NOVEMBER, 1961

The Controller

EDITED FOR CORPORATE CONTROL & FINANCIAL EXECUTIVES

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INDUSTRIAL RESEARCH MUST BE PLANNED AND CONTROLLED

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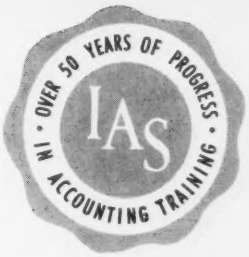

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Correspondence

REBUTTAL TO ZISES' COMMENTS ON LEASE FINANCING

Editors, THE CONTROLLER:

I have read carefully and with great interest the Correspondence section of the September 1961 issue of THE CONTROLLER. My comments following* constitute a rebuttal to Mr. Zises' comments concerning financial statement disclosure of long-term leases.

TED M. RABUN
Assistant Professor of Accounting
College of Business Administration
The Pennsylvania State University
University Park, Pa.

* Alvin Zises presents some very interesting comments about disclosure of long-term leases, beginning on page 414 of the September 1961 issue of THE CONTROLLER, but beneath his comments are a few misconceptions concerning accounting and financial reports.

First, Mr. Zises' principal argument and one that permeates most of his comments is that significant legal distinctions between leases and legal title to property justify reporting leased equipment and owned equipment in different ways. He states: *"Another has been the recording of debt in the balance sheet as the legal liability. Any figure placed on the liabilities side of the balance sheet for long-term contracts would not, within one chance in a thousand, be the amount of legal liability."*

It is *not* true that the liabilities section of the balance sheet reflects legal liabilities; rather, it should reflect economic liabilities. The distinction is important, and it is this distinction that has produced such economic liabilities on the balance sheet as deferred tax liabilities, accruals for vacation and sick-leave pay (not vested), and liabilities for law suits pending. Even the stockholders' equity section of the balance sheet does not show legal amounts as is frequently believed. The retained earnings account does not show amounts legally available for dividends, and neither the capital stock accounts nor the total stockholders' equity section shows the legal rights of stockholders to assets.

If long-term leases and similar liabilities are or are not to be reported within the main body and totals of the balance sheet, the decision must be made on economic instead of legal grounds. Legal decisions and principles concerning the rights of parties to a lease or any other commercial transaction of necessity *follow* rather than lead the economic transaction, and these same decisions have legal rights instead of economic rights as their focal point. Financial reporting by a corporate entity has always been focused on the economic corporate entity rather than on the legal-rights corporate entity. This time-honored function of financial statements is, in fact, the only logical one, for otherwise income determination and balance sheets would, in many instances, await the decisions of the courts. Even Mr. Zises would not, I believe, advocate this.

Second, Mr. Zises quotes: *"The capitalization of leases logically would dictate the inclusion of the current portion of them in current assets and current liabilities. . . . Would we not compound a serious problem for many corporations which in their loan agreements may have a provision requiring the maintenance of a certain relationship between current assets and current liabilities? The corporation in question may become a technical violator of the loan agreement."*

There is no question about the need for reporting the current portion as a current liability if the leases are recorded. But Mr. Zises infers that bookkeeping entries have a substance to them. He is clearly mistaken in this. *Do such entries determine what has happened, or do economic transactions dictate that entries should be made?* Carrying Mr. Zises' reasoning to its logical conclusion leads one to believe that whatever is recorded is economic fact, and anything not recorded, though it may or may not have happened, did not occur. This erroneous reasoning would mean that a corporate entity has less assets after the end of the first year in business if it adopts, say, declining-balance depreciation instead of straight-line de-

DO YOU AGREE *or do you disagree with an article in this month's issue? Your fellow readers will be interested. Naturally, letters to the editor must bear the writer's signature and address; these will be withheld on request. The Editors*

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CONCEPT OF MODERN CONTROLLERSHIP
of Controllers Institute of America

1. To establish, coordinate and administer, as an integral part of management, an adequate plan for the control of operations. Such a plan would provide, to the extent required in the business, profit planning, programs for capital investing and for financing, sales forecasts, expense budgets and cost standards, together with the necessary procedures to effectuate the plan.

2. To compare performance with operating plans and standards, and to report and interpret the results of operations to all levels of management and to the owners of the business. This function includes the formulation and administration of accounting policy and the compilation of statistical records and special reports as required.

3. To consult with all segments of management responsible for policy or action concerning any phase of the operation of the business as it relates to the attainment of objectives and the effectiveness of policies, organization structure and procedures.

4. To administer tax policies and procedures.

5. To supervise or coordinate the preparation of reports to governmental agencies.

6. To assure fiscal protection for the assets of the business through adequate internal control and proper insurance coverage.

7. To continuously appraise economic and social forces, and government influences, and interpret their effect upon the business.

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The Controller

C O N T E N T S

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preciation. The error, of course, lies in thinking that the accounts and financial reports are something other than *a measure* of the economic fact. Declining balance depreciation results in a smaller *measure* of assets at the end of the first year, but it does not mean that there is a smaller amount of physical assets. The assets will not react to the bookkeeping entries for recording depreciation; they react only to economic stimuli.

Following the same reasoning, we cannot say that leases should not be recorded since to do so results in additional current assets and liabilities. The *economic* fact is that there is or is not an economic liability for long-term leases. Once this fact has been established, then, and only then, an entry should be made. Notice again that the second quotation above implies that the decision to capitalize and record may precede an awareness of a liability.

Can it be true that a corporation which does not show the long-term lease is tangibly any worse off than one that does?

Is it not true that the loan agreement was possibly improperly worded?

Do people who read financial statements want liabilities to be defined by loan agreements?

This is certainly a novel idea in financial reporting. A proper relationship between current assets and current liabilities is disturbed by economic facts, not by journal entries that are either properly or improperly made. The discussion by Mr. Zises leads one to believe that merely by refusing to record leases as a liability, a liability cannot exist. *Would he also suggest that by not recording the depreciation of a year a company has more income and is thus in a better financial position?*

Third, Mr. Zises states that *"In many states, because of the actual wording of the statute or because of administrative interpretation, the leased assets so capitalized would be subject to ad valorem, corporate franchise, or other taxes."*

Here again is a fallacy similar to the one preceding. *Is there a controller or management so naive as to make "book entries" when to do so would increase operating costs?* If it can be determined that taxes will be increased by making an entry for leases, it is a rather simple and perfectly legal alternative to make "memorandum" or no formal entries for the leases. Make a worksheet entry. There is nothing sacred about a debit and credit journal entry in a bound book, and few states require that reports used for tax purposes must agree with reports used for *all* other purposes. Certainly accounting and reporting standards can ill afford to follow ad valorem tax reporting forms.

A fourth misconception by Mr. Zises is his obvious concern with differences between leased and owned property during bankruptcy proceedings. Except in cases of imminent bankruptcy, the underlying assumption in accounting is that the entity is a going concern. Financial reporting is not traditionally governed by what *may* happen in the event of bankruptcy. As a going concern the entity will make either leasehold payments or periodic payments for the purchase of property. If it is headed toward bankruptcy, it will do neither. The *economic* consequences are the same to the going concern.

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Editors, THE CONTROLLER:

In THE CONTROLLER for June 1961 you made reference to an article in the April 1961 issue of *Business Record* magazine. I would be interested in obtaining a copy of this issue and would very much appreciate information as to whom to write for it.

GERALD F. MEYER
Budget Analyst
National Cancer Institute
Bethesda, Maryland

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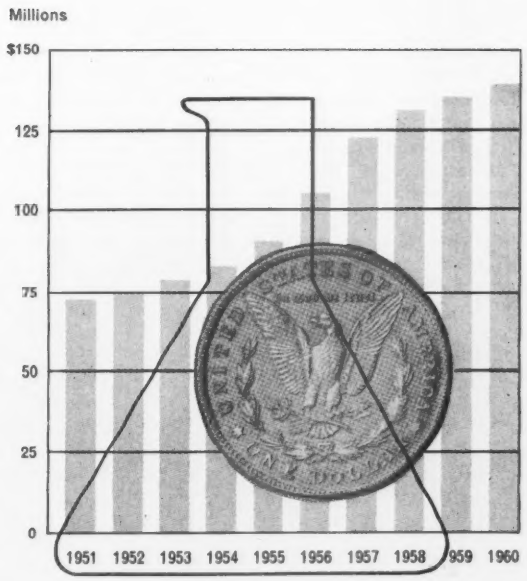
J. A. McFadden, Jr.

Industrial Research Must Be Planned and Controlled



Scientific and intellectual freedom, so highly prized by good researchers, must be kept within rational boundaries and their investigations must be directed to the commercial profit aspects of their employer's business

WHETHER OR NOT it is possible to plan and control industrial research is perhaps the most controversial of all the management questions facing modern industry. When the question *Can research be planned and controlled?* is asked, one should hesitate before offering a monosyllabic answer, either positive or negative. An answer cannot be made without considering the definition of the word "research" and also the purpose for which the research is conducted. Further, it would be well to consider the question as being two questions. One is *Can research be planned?* and the second *Can research be controlled?* The matter of planning and controlling the resulting costs cannot be accomplished effectively until both these questions are answered.

PLANNING RESEARCH— PROBLEMS AND APPROACHES

In considering, first of all, *Can research be planned?*, it must be realized that not only can it be planned but also that it *must* be planned if a company wishes to survive in today's industrial economy. It is not necessary to belabor the many reasons why research must be conducted in accordance with a planned program. It is sufficient to realize that any enterprise wishing to maintain or improve its position in a given market or industry must conduct a planned research and development program to advance knowledge in scientific fields that will produce commercial profits either sooner or more surely. It must be recognized that the decision as to whether the plan is a prudent one is always a calculated risk because of a lack of definite knowledge of what research is being done in other parts of the scientific world by, or for, competitors. In this respect any one company, regardless of its size, generally cannot exercise control over more than approximately one per cent of the research being done in any scientific area. Hence 99 per cent of the research and possibly 99 per cent of the knowledge in any given field of scientific interest is in the hands of others. The simple matter of a company's ability to attract scientific talent will limit its knowledge in a given technology. Geographical location, scientific interests and loyalties, academic pursuits and other incentives not monetary in nature would prevent any organization from obtaining a so-called "corner" on the offerings of any sphere of influence in any area of knowledge.

The research planning process continues to be somewhat like the proverbial enigma, *Which came first, the chicken or the egg?* It is always necessary to realize needs and desires before any attempt to make discoveries or inventions. After concepts are rather well decided and perhaps even defined, there are other facets to the problem which require constant attention. For example, scientists do not as a rule start out as industrial researchers. It takes time and much effort to make industrial researchers realize that their company employer has a particular business. Accordingly, scientific and intellectual freedom, so highly prized by good researchers, must be kept within rational boundaries, and their investigations *must* be directed to the commercial profit aspects of their employer's business. Also, it is constantly necessary to steer researchers away from gadgetry which is easy to develop but usually does not add very much to the corporate coffers. On the other hand, a company wishing to research a particular area of scientific interest may find that the curiosity of the scientists cannot be stimulated because of "old hat" technical concepts and the problem of staffing a project is presented.

Current interest in projects related to satellites, space vehicles or applications of nuclear energy makes extremely difficult the matter of exploring the commercial possibility of thermoelectric devices inasmuch as the fundamental principles of this phenomenon were discovered by a French scientist during the sixteenth century. At least this attitude is prevalent amongst industrial researchers who have only recently completed their academic studies of the sciences.

Not all discoveries in the research laboratory are a major breakthrough in terms of new scientific theory or principles. Often the most important discoveries from a commercial application standpoint stem from a reaffirmation of scientific theories that were proven decades or perhaps centuries before the birth of the scientist involved. Nevertheless, modern-day scientists are prone to favor with their intellectual efforts the more modern scientific theories. Old theories lack glamorous appeal to researchers due to the passage of time and due also perhaps to the lack of developments from them. While new phenomena, plus inventions which customers need and desire, should be the continuous goal of the industrial researcher, older theories, techniques and developed phenomena should not be neglected when it appears that further study and development may lead to commercially profitable applications.

A further consideration in the research planning process is the fact that there exists little justification for improving products beyond the consumer's maximum requirements. Or, when minimum customer standards or a competitor's offerings cannot be attained by present techniques, a decision must necessarily be made whether to research further to meet or exceed both levels. The alternative is to abandon the project and devote the time and effort to other areas of interest. *Exhibit 1* illustrates graphically the analysis that can be applied to a particular research project to determine the feasibility of continuing exploration or to consider the task unworthy of further effort.

Assuming that a product, service or system in 1950 is below both the customer's minimum requirements and a competitor's product standards, it is necessary to plot in terms of time and money the effort required to rectify the situation. The position indicated in 1952 is not acceptable because, although the customer's minimum requirement will have been met, the competitor's product is still superior. In mid-1953 a competitive position only has been attained. The amount of commercial advantage, if any, that may be gained by exceeding the quality of the competitive product must be weighed at this point. Assuming that maximum customer requirements can be accomplished through additional research effort by early 1955 and market advantages will offset the additional expense of the development required, the project should then be terminated. Funds and effort should not be authorized to accomplish technological perfection which will produce only scientific satisfaction and add nothing to the financial profit structure.

The planning of research and development and the problems incident to it are by no means uniform in every company. As a matter of fact, similar companies in the same industry may experience an entirely different range of problems in planning *when, how* and *to what extent* they should direct their research efforts. It can be appreciated that a brewing company with the customer's needs and desires so vividly demonstrated in every tavern and bar does not encounter the problem of the electronics company with a diversified product line, ranging from turbines and transmitters to computers and high energy convertors.

Hence, research can and must be planned. It can be planned by determining through market surveys the improvements that can be made to present products to make them more desirable and acceptable at the market place. It can be planned by developing new products for which there already exists a need and hence a market potential. It can be further planned by a long-range program in the basic sciences for the purpose of producing new discoveries and inventions which will make obsolete existing products, processes, techniques, and so forth. It can be planned by directing the efforts of the industrial technical staffs along lines that will concentrate the researching in areas which will contribute to the company's present or future profits.

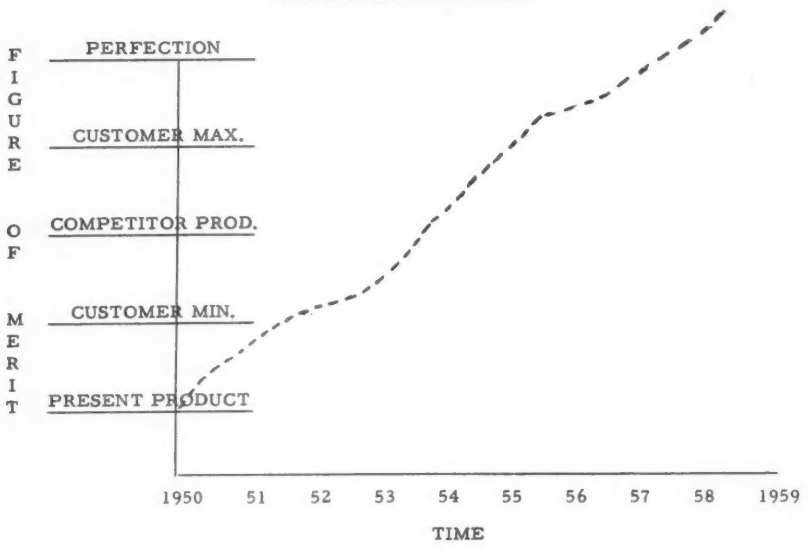
CONTROLLING RESEARCH—DEGREE DEPENDS ON TYPE

In considering *Can research be controlled?* it is important to realize that the chief difference between a research program and a production or other commercial operation is *what* is being done and not *how much*. Also the degree of control that can be exercised will depend upon whether the project is in the area of basic research, applied research, advanced development, product development or production engineering. It is indeed unfortunate that the caption "research" is used to define any effort ranging from choosing door knobs for a school bus to studying the genetic effects of nuclear irradiation damage in humans. Fundamental research in the basic sciences can only be controlled, if controlled at all, by assigning the best qualified scientists available to conduct investigations which it is reasonably expected may expose phenomena, the principles of which may be conducive to commercial exploitation.

A constant monitoring of the research program by the research director is necessary to assure that the projects authorized are in the best commercial interests of the company or industry concerned. Each project must be assigned to the best staff members in the respective scientific disciplines involved, and, to a reasonable degree, adherence to the project's objectivity must be required by periodic technical progress reports. Almost every

EXHIBIT 1

INDUSTRIAL LABORATORIES
PROJECT 60—SALT SPRAY



scientific researcher has a pet theory or project which he will constantly attempt to further under the guise of pleading an environmental requisite of intellectual freedom. The importance of a certain amount of intellectual freedom in industrial research cannot be denied so long as such freedom does not spend the research budget on studies unrelated to the particular company's business purposes.

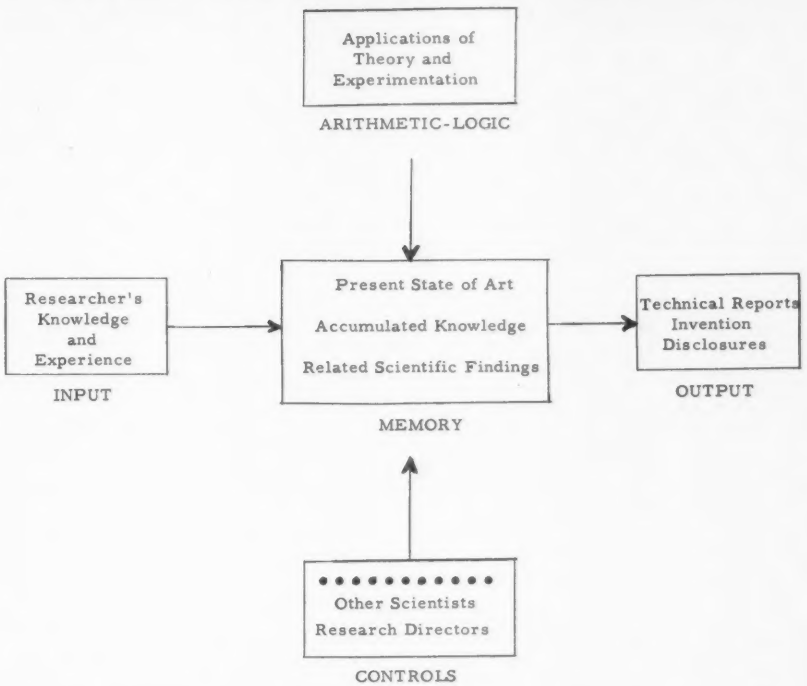
Applied research and advanced development can be directed to a greater extent and controlled somewhat more than basic research. In cases it can be found that such direction and control can be exercised, however, to only a nominal degree. Again the knowledge and imagination of the individual are involved and, as in the case of basic research, the scientists need to possess unique talents. Therefore, direction or control, except for that applied to the basic research program, may prove extremely difficult and in instances is moderately inadvisable.

In the control or direction process of basic research, applied research or advanced development program, it is necessary to evaluate the contributions of the members of the scientific or technical staff somewhat in the manner that one views the performance of an electronic computer. Electronic computers, like research programs, are both very expensive and very complex. Once the input data and program are fed to the computer, the operator really does not know whether the machine is doing the job properly or whether the correct answer will be forthcoming, until the output is recorded by the printer mechanism. Similarly, when a researcher is assigned to a research project or task, he in effect applies or adds his experience and knowledge (input) to a great store of scientific knowledge accumulated by others in developing the current state of the art (memory). The application of the researcher's knowledge and experimentation may advance the present state of art or add to it (arithmetic and logic). Eventually, this process will produce certain results, such as technical publications or invention disclosures (output). Directing the efforts of the individual researcher by consultation and colloquium along the lines of project objectivity will be accomplished by senior members of the technical staff, laboratory directors, the research director or other members of the general scientific community (controls). *Exhibit 2* illustrates, in the style of the electronic computer sequence, the manner in which researchers contribute to the over-all research and development program.

An individual researcher may work for a long period of time only to find that the answers being sought are either unsuitable or unacceptable for the intended purpose. In short, the result is negative. Such a conclusion does not indicate poor planning and control. On the contrary, a negative result might be very profitable, particularly if it is proven that to spend more time, money or effort in the chosen direction would prove fruitless. Also, a very valuable scientific gain may have been accomplished. The thesaurus of scientific knowledge has been updated and may well prevent the spending of additional funds, pursuing a theory which has been conclusively proven to be unsound. In addition, the researcher's knowledge and experience may be greatly enhanced, and, in the future, the theory and experimentation explored in this particular task, while not fruitful at the time performed, may serve as the basis for solving related or perhaps even totally unrelated future problems.

EXHIBIT 2

APPLICATION OF SCIENTIFIC EFFORT TO A BASIC RESEARCH PROGRAM



In product development and production engineering, the possibility of control increases greatly. Engineering standards, greater appreciation of goals, performance criteria, and other realistic measurements are available to permit positive application of controls over both funds and effort. These areas of development do not contain the degree of uncertainty of objective which is ever-present in the pursuit of knowledge in the basic sciences. A much more positive application of principles and theories with a more certain expectation of results is possible. Accordingly, the matter of project or program control in terms of effort application and expenditure rate is capable of more definite realization.

COST PLANNING AND CONTROL NOT DIFFICULT TO APPLY

Beyond the planning and control of the technical aspects of the research program, it is certain that research costs can be both planned and controlled. The cost control philosophy and technique in such a process, however, differs materially from that which is normally employed in the management of any other type of business endeavor.

Controlling total cost is simple. So is the control of *where* or *on what* the total cost is spent. The former is dictated by the size of the scientific staff employed and the amount of facilities and equipment required for the research function. With the shortage of scientific personnel in this country, the problem is to find adequate talent to staff the research effort. This element of cost, therefore, in the aggregate, cannot fluctuate appreciably during a normal fiscal period. Once the facility and equipment complement is accomplished, additions and replacements can be planned and controlled within operating periods. Hence the planning or budgeting of costs is merely an exercise

of computing the salary and related cost of the technical and supporting staffs, together with the pricing of the space and equipment expenses involved.

Because of their nature, none of these elements of costs can change significantly during a given period and although, due to unusual circumstances, they might, any such change will be anticipated in advance. Additions to staff cannot occur without advance planning and knowledge. Additional facilities in terms of floor space requirements occur infrequently and usually only as a result of a premeditated increase in the scope of the program or changes in emphasis requiring entrance into new or different fields of scientific interest. In most research organizations, the cost of materials and supplies normally represent only a very minor percentage of the research budget and, except for major changes in the scope of the research program, this cost element does not vary greatly from one period to another.

In the conduct of an industrial research program, the prime object should be one of maximizing the returns from the research investment. This can best be accomplished by guiding the research effort into pathways related to the company's business objectives. Research results are a matter of much uncertainty. However, by guiding the program in a planned direction, the results can definitely be influenced and, to a great degree, controlled. In the normal industrial research laboratory a number of projects will be authorized, and the control of *where* the scientific staff and facilities are deployed will be maintained by the research director. Accordingly, *where* the costs are applied and *how* they are applied within the framework of the authorized projects can only be controlled by research management.

The make-up of the research program in terms of projects is the important form of control that must be exercised. Such control does not necessarily mean that less money will be spent, nor that costs will not exceed previously allotted budgets or appropriations. The real control attained is that the company's management prescribes the projects and scientific problems to which the research staff will apply its efforts. Perhaps, in the process, it will be revealed that additional staff and facilities are required to protect a market position or to produce substitutes for unprofitable products.

The decision as to how much will be spent on research and development and the projects to which such funds shall be applied, assuming that talent and facilities are either present or can be recruited or acquired, can only be made through the collective effort of a sophisticated team of management experts. Most large companies rely upon a research planning and policy committee. Usually such a committee will be composed of the following corporate executives:

President
Research director
Vice president-finance
Patents director
Marketing director
Product planning director
Manufacturing executive

BUT THERE ARE COMPLICATIONS

In the planning and controlling of industrial research, there are many factors that will affect (1) the qualities of the results attained and (2) the cost of obtaining the desired complement of results.

First, there are the factors which are created or governed by the corporation or laboratory entrepreneurs. Some of these factors are:

1. The organizational environment in terms of the goals of the corporation. When goals in terms of desires and requisites for products, processes, systems, etc., are clearly defined much is accomplished to encourage the scientific interest of the researcher and generally more creative results ensue. In the absence of definite goals an atmosphere of low moral and poor scientific effort will prevail.

2. The authority or management influences on the scientific staff. The industrial researcher resents the awkward attempts made by certain members of the management team to enforce planning and control procedures in the research organization which were designed for manufacturing or service types of operations.

3. Recruitment, selection, training and development policies. In the recruitment and selection of additions and replacements for the technical staff, intellectual and experience standards of candidates generally must be maintained at a level equal to or above the average for the scientific group as a whole. Adequate provisions must also be present for the researcher to obtain continuous scholastic and practical training and development.

4. Operational organization as reflected in the structure of the research working groups. Proper organization of "research teams" in terms of education, training and scientific reputation together with proper instrumentation and technical assistance is of prime importance to the industrial researcher.

5. The system of rewards and recognition adopted. Compensation in a scientific discipline must be related to scientific achievement for the most part. Complex technologies seldom permit realistic relationship between the commercial end-product and contributions of the individual scientist in terms of rewards or recognition. Hence, the individual must be recognized and rewarded for the contribution made to the general pool of scientific knowledge as well as for specific, apparent product accomplishments.

6. The selection of research areas. When the nonscientific members of management play a major role in the selection of research projects there is danger that much scientific incentive will be lost as a result of lack of faith in the program upon the part of the researchers.

In the *second* place, there are the ingredients introduced by the presence of the scientists and their role in industrial research. While an industrial research

CHARACTERISTIC OF OUR AGE

A hundred years ago the way to advance physics and chemistry seemed to be by making more and more measurements. Science then was a quantitative affair, and this 19th-century picture of the scientists preoccupied with numbers—the picture of Phineas Fogg at the beginning of Jules Verne's "Around the World in Eighty Days"—is still large in the popular mind.

But in fact the concern of science in our age is different: it is with relation, with structure and with shape. Today we hardly ask how large space is, but whether it is open or closed on itself. We say that rubber stretches because its atoms are strung out in chains, and the diamond does not because the atoms are locked in a closed pattern of rings.

—J. Bronowski *in a special report on* "The Creative Process" *in Printers' Ink, January 13, 1961.*

laboratory must always be a rational, purposeful entity, this fact does not prevent, nor is it intended to preclude, irrational behavior on the part of its researchers. Some of the common characteristics found in scientists which will influence the effectiveness of a research operation are as follows:

1. **Intellectual attainment desires.** The continued interest of the average research staff member can only be maintained in projects or programs which not only permit but assure the possibility of intellectual attainment.

2. **Professional recognition aims.** Researchers and scientists view professional recognition as the apex of accomplishment and hence their loyalties are much stronger to the scientific community than they are to their industrial employer.

3. **Intellectual freedom requisites.** A multitude of sins are committed in industrial organizations under the guise of intellectual freedom. However, the scientific or technical employe virtually holds this requirement as a knife at the throat of industrial research laboratories.

4. **Budgetary autonomy aspirations.** While contrary to the fiscal planning of any profit-motivated commercial operation this condition is a matter of constant striving by the industrial researcher.

5. **Financial reward expectations.** Irrespective of the concessions obtained with respect to items one to four the scientist in industry is still a human animal and insists upon being rewarded financially at the highest possible rate.

6. **Management status consciousness.** In recent years, those engaged in technical and scientific pursuits by industrial employers aspire to organizational titles and management status.

It is obvious upon comparison of the two sets of factors that a conflict of objectives exists. Fundamentally, the conflict lies in the differences in economic values of management and the research scientist. The solution to astute management planning and control for the research organization is found in the method by which these differences are reconciled. It is obvious that, in order to approach such a reconciliation, changes in personal attitudes, business philosophies and measurement criteria are necessary upon the part of both the scientists and the business and financial managers of industrial organizations.

Financially motivated organizations cannot be entirely adapted to high-talent scientific manpower's dreams of professionalism, tenure and budgetary autonomy. These expectations on the part of the industrial researchers would not be quite so unrealistic if they were willing to accept some of the risks inherent in such desirable circumstances. Association with organized labor movements, the absence of capital investment and the risk of income collection, the assurance of retirement, health and life insurance benefits create a situation wherein claims of professionalism and tenure cannot be viewed in an industrial economy as anything more than idealistic whims. When the researcher decides to face the economic facts concerned with the operation of an industrial research laboratory, the sooner he will shed some unnecessary involvements and be able to enjoy his scientific pursuits more thoroughly.

Conversely, scientific manpower cannot be adapted to the economic goals of an organization in the same manner as can other types of high-level manpower, without diluting the technical quality of the research program. Sufficient latitude should be provided for the researcher to satisfy his need for recognition and self-realization. Opportunities should also be present to allow for proper career development and attainment of professional or management status. Attempts by controllers, business managers or other corporate executives to account for, control or measure the operations or operating results of a scientific research effort by the same theories and procedures employed in a manufacturing organization are only an indication that they do not understand the underlying purpose of a research and development program. Of much more serious proportions is the fact that such efforts will probably defeat to a great degree the very reason for which the program was established.

The real contribution that the controller's organization can make in the over-all control of research and development expenditures is to assure through selective audit procedures that funds are expended for the purposes that are genuinely related to the search for knowledge in line with corporate objectives. Such procedures should be structured to permit the application of controls prior to the commitment of funds. Account analysis after the fact accomplishes very little in the way of management control unless steps are taken to provide against repetition of transactions which are found to be outside the sphere of company policy and intentions. Controls on acquisitions of instrumentation, foreign and domestic travel policies with respect to attendance at symposiums, colloquium and technical society meetings, salary administration standards and their application, adherence to leave of absence rules for personal or educational purposes are examples of areas in which the corporate controller should play a major policy-making and police-action role. Extreme care must be exercised, however, in recognizing the specialized nature of the operation. Standards of measurement must be realistic and must be flexible to allow for unusual circumstances that are constantly present in a scientific atmosphere. On the other hand, industrial researchers are prone to ignore or, even worse, dispute regulations when they have a tendency to disclose deliberate departures from the sound economic principles of even the most sophisticated organized effort.

By nature the scientist is a "string saver" and will hoard equipment or instruments necessitating excess acquisitions if proper surveillance is not exercised. Also expensive, complex instruments are occasionally coveted without a full knowledge or appreciation of their utility value.

Salary scales when entirely administered by research or personnel people can be

ABOUT THE AUTHOR

• J. A. McFADDEN, JR. *was named director, Administrative Services, RCA Laboratories, Radio Corporation of America, Princeton, N. J., in January 1957. He was formerly controller, RCA Laboratories, and before joining RCA in 1942 held various accounting and treasury positions in the textile, ceramics and nonferrous metal refining industries. He is a CPA, and a graduate of the Wharton School of Finance of the University of Pennsylvania with a B.S. degree. He did specialized study at the Graduate School of Engineering, New York University, from which he received his M.S. degree. In 1960 he was the recipient of an honorary LL.D. degree from Rider College. He is a member of Controllers Institute and the American Accounting Association and has served as a vice president and director of the Philadelphia chapter of National Association of Accountants. Mr. McFadden has received Lybrand Certificates of Merit for four of his papers contributed to the NAA Bulletin and is co-author of the text book "Accounting and Tax Aspects of Patents and Research" (D. Van Nostrand, 1960).*

influenced by emotional and personal factors which over a protracted period of time destroy the confidence of the technical staff. Compensation ranges must be determined and approved periodically and adhered to except for unusual, isolated cases involving scarce or outstanding scientific talents.

Attendance at technical society meetings, symposium and colloquium, which involve not only the salary expense of technical personnel but quite frequently sizable sums for travel, living and registration expense, is a matter, although somewhat more difficult to control, that can nevertheless add appreciably to the cost of the research program. Individual cases which may be the subject of scrutiny usually do not cause concern, but may establish precedents which when multiplied by the number of annual cases possibly could result in sizable expenditures. Unless it can be supported that attendance at such meetings will at least contribute directly to the work being performed on a project or will enhance the scientific knowledge of the individual, attendance should not be encouraged by the research director. Seldom does attendance by a large group en masse accomplish either of these aims. The establishment of an average sum of money per member of the technical staff for such purposes will result in nothing more than a device to encourage the spending of money even though the benefits are nil or at the best only social in nature.

Unauthorized departures from specified work attendance schedules represent the most difficult, from a control standpoint, of all the practices encountered in the industrial research laboratory. It is conceded that, to a certain degree, hours spent in the laboratory are not a measurement of a researcher's creative productivity. By the same token, unless proper supervision is exercised at the research department level there is a tendency on the part of scientific personnel to completely overdo the matter of freedom of movement. Hence, items of absence for purely personal reasons, reasonable compliance with working hour schedules, vacation and sick leave policies, and so forth should be the subject of constant, joint concern of both the research director and the controller. It is not recommended that attempts be made to regimentate industrial researchers; however, irrational behavior in these areas tends to be infectious to a point where administrative and service personnel, if control is not exercised, will expect, and in fact insist upon, the same privileges. Such a state dilutes the over-all quality and quantity of the scientific effort by providing less research for each dollar spent.

THE GOVERNMENT COULD SET AN EXAMPLE

Not only can industrial research programs be planned and controlled, but they must be planned and controlled. Such planning, in fact, should go far beyond what an individual company or industry is capable of doing. Considerably more planning should be done by the agencies of the Federal Government which are annually dispersing funds for research and development far in excess of the total amounts spent by industry on their own account for this purpose. Aside from the technical planning associated with government-sponsored research and development projects, much more planning should be accomplished in the area of cost principles, procurement and contracting. Armed Services Procurement Regulations, and more particularly the application of such regulations by the procurement and cost inspection agencies of the Federal Government, leave much to be desired. The matter of patent clauses, allowable direct costs, record and accounting requirements, overhead application negotiations, security requirements and the cost thereof, recovery of independent research and development costs and other equally important considerations should be reviewed to recognize that industrial research cannot be planned, controlled or managed under the same set of ground rules employed with respect to mass production operations.

Revision No. 50 of ASPR, issued November 2, 1959, purports to allow the recovery of a pro rata share of the cost of a contractor's basic and applied research programs. However, the method of, and basis for, such recovery are surrounded by sets of conditions that do not induce industry to spend private funds for research and development in the manner intended when President Eisenhower personally endorsed Congressional Bill No. HR 4797. The Bill, introduced in the House of Representatives of the United States on February 19, 1959, is intended to encourage basic research in science by amending the Internal Revenue Code of

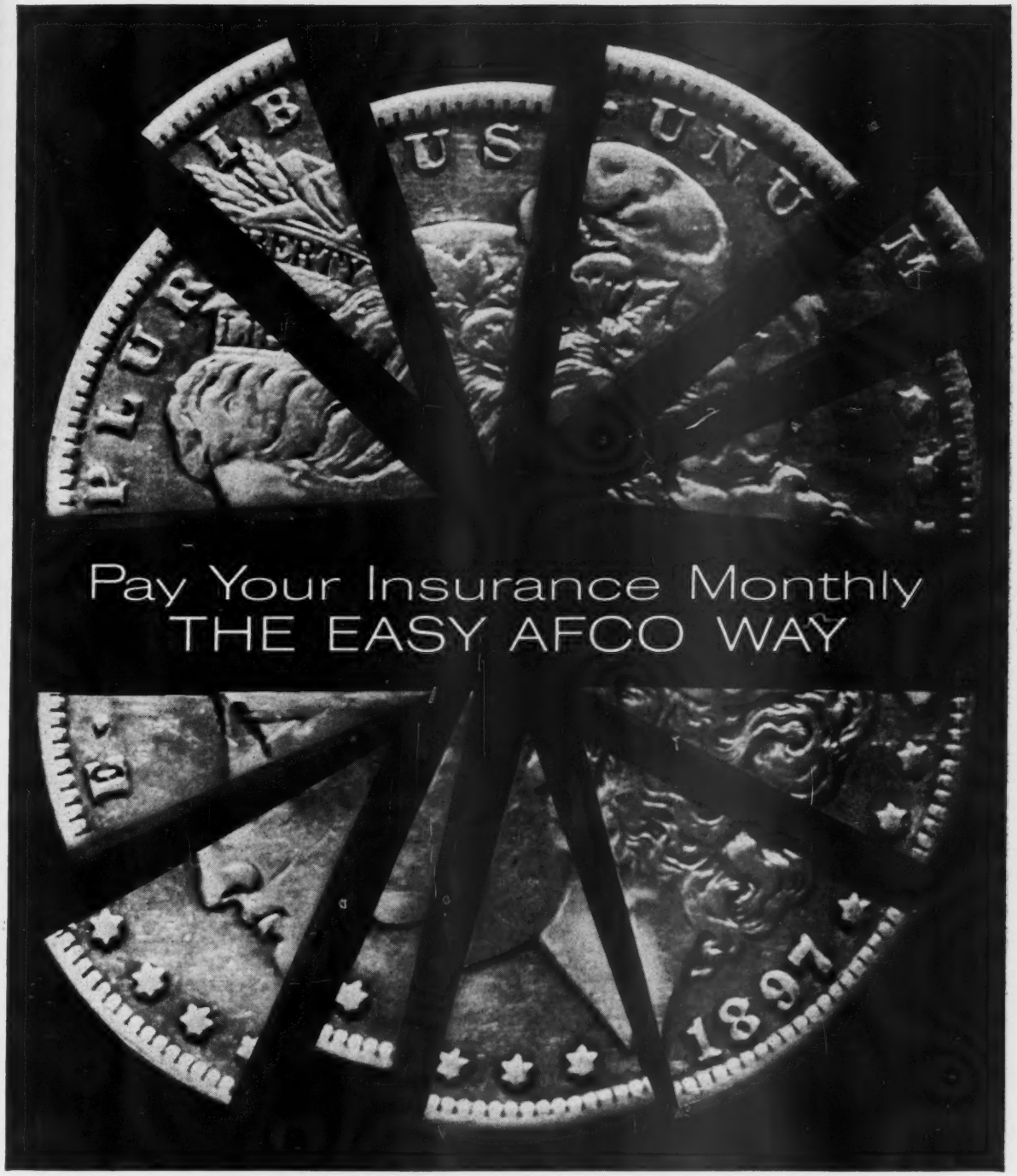
(Continued on page 560)

The scientific mind is an inquiring one. In terms of industrial research it asks such questions as: *Has this proposed study been accurately defined and oriented? Have the useful properties of this new material been exhaustively considered? Could it be solutions are in unconsidered technologies? Have associated factors been studied as a potential causative? Have human relations been surveyed as an influencing factor on the technical deficiency?*

Administrative people would also ask such questions about research considerations if they had the professional training to pose the proper ones. The management mind is also inquisitive . . . so the two have much in common.

From
CAN THE RESEARCH SCIENTIST ACQUIRE A MANAGEMENT ATTITUDE?

a printed discussion now being offered by Battelle Memorial Institute to representatives of industry concerned with research and development. Written by M. R. Nestor, Battelle's manager of project development, the statement is one of a series on the procedures and characteristics of contract research for industry being published by the Columbus, Ohio, research center. BMI is also offering a colorful chart of the fields of scientific research covered by BMI in its fundamental and applied studies, materials science, product and process development and design, and market and economic analysis to further American industry.



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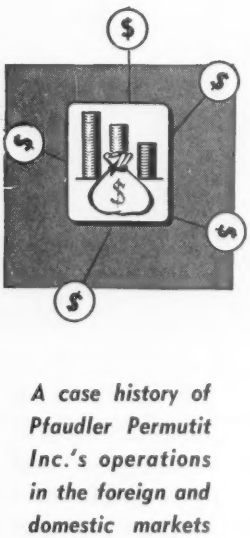
American Private Investment Abroad



A case history of Pfaudler Permutit Inc.'s operations in the foreign and domestic markets

IN ORDER to provide a proper frame of reference, it is necessary to present some background data on our company.

The Pfaudler Co., predecessor to Pfaudler Permutit Inc., was organized in 1884 and was originally engaged in the manufacture of brewery equipment. The company gradually underwent a product transition and by the early 1940's it was a producer of specialized equipment for the process industries—chemical, pharmaceutical, food, beverage, dairy and brewery. Its specialty was the coating of glass on steel. This, plus special fabrication know-how, resulted in the ability to produce equipment with unique characteristics of corrosion resistance, heat transfer, thermal shock, and noncontamination of product, which were of vital importance to a broad segment of industry.

By the early 1950's the company's sales had reached an annual volume in the $12-$15 million range. During this period, the increasing complexity of modern business resulting from very rapid economic and political developments, not only on the national but also the international scene, caused us to reappraise our particular situation. After a careful analysis, we reached two conclusions:

First, that in order to keep pace with the new concept of a global economy, we had an acute need for internal "management specialists" in the fields of research and development, marketing, manufacturing, industrial relations, finance and control, and

Second, a company of our size just did not have sufficient sales volume to afford these specialists.

This forced us to confront the problem of how to increase our size and improve our effectiveness. We established for ourselves a goal of "Sixty by Sixty"—a sales volume of $60 million by the year 1960. Notwithstanding our desire to grow, we imposed on ourselves one condition; namely, that we would not attempt to spread in all directions at once and thereby become a conglomeration of unrelated businesses.

WE ESTABLISH A PROGRAM

After considerable discussion and analysis, we set forth in 1954 on a balanced three-pronged program which we felt would give us the growth and degree of diversification we needed without jeopardizing the strengths of the business we already had. These three prongs were based upon internal development, external expansion (growth through acquisition), and expansion abroad.

Internal development was implemented by recruiting carefully selected, well-qualified people in the five functional areas of business; the management specialists previously mentioned.

External expansion was undertaken by establishing a small top-management staff to develop a planned acquisition and merger program. In the ensuing years, several small companies were acquired, whose operations were fully integrated into our existing organization. The highlight of this external expansion program was achieved in 1957 when the Permutit Company was merged with the Pfaudler Co., resulting in the formation of Pfaudler Permutit Inc. The Permutit Company was a well-established firm engaged in the design and manufacture of water-conditioning equipment. It also produced ion exchange resins for use with this equipment, as well as chemical compounds formulated for special applications in water treatment.

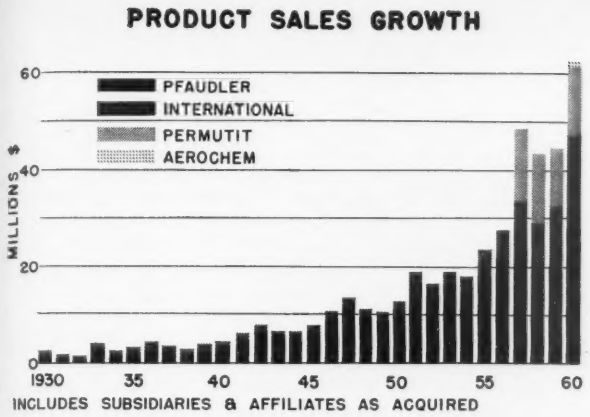
The third segment of this three-pronged program was *international expansion.* Our company already had some knowledge and experience in operating abroad as a result of owning a German subsidiary since 1907, and 50 per cent of a British affiliated company since 1933. From this base of foreign operations, we expanded into Japan in 1954; into Mexico in 1956; into Canada in 1959 and into Brazil late in 1960.

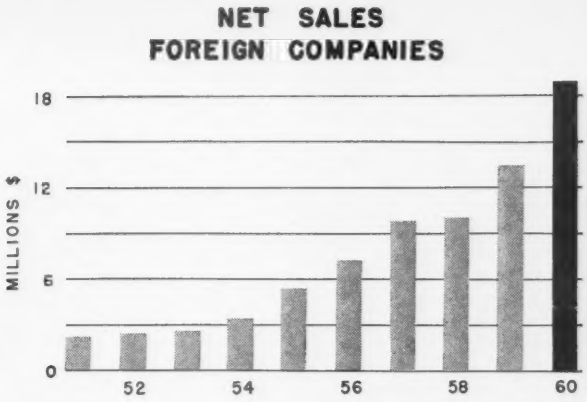
Today, corporate management of Pfaudler Permutit operates through four divisionalized profit centers: the Pfaudler Division, Permutit Division, AeroChem Research Division and the International Division. Our combined efforts, internally and externally, appear to have achieved the desired result during the year 1960 when our company reached an all-time peak in orders received, shipments and earnings. Our objective established in 1954 of "Sixty by Sixty" compared with an actual shipment volume of $62,030,000, representing total shipments by the company and all its foreign subsidiary and affiliated companies during that year.

Of all the activities within our company, our operations abroad achieved the most dynamic growth during this seven-year period. This is clearly demonstrated by the increase in total combined sales of all foreign subsidiary and affiliated companies from $2 million prior to 1954, to more than $19 million in 1960. It is this portion of our activities that I should like to dwell upon, to outline the history of our operations abroad; and to compare the income remitted to the United States versus the amount invested to generate this income.

WE BRING THE MOUNTAIN TO MOHAMMED

There are many reasons why we were, and continue to be, desirous of investing in plants abroad. First, there exists in foreign markets, a tremendous demand for those products which constitute the major portion of our domestic business,





namely glassed steel equipment for the process industries, principally chemical and pharmaceutical. Many of the customers of our foreign plants are themselves subsidiaries of Pfaudler Permutit's domestic customers. Second, our products are for the most part custom built, and the problem of communication from the United States, and more importantly, the problem of rendering adequate service in connection with their proper use and maintenance, would be almost unmanageable, if we attempted to do this from here. Third, the physical size and weight of our products is such as to render distance a competitive disadvantage. Therefore, if we were not present locally, the business we enjoy would surely fall to competitors in each of these areas. I include not only competitors in our line of products, but also in competitive materials of construction.

CAPITALIZING ON FOREIGN MARKETS

Let me now explain the operations we have been developing to capitalize on the potential of foreign markets.

Germany

Our wholly owned German subsidiary, Pfaudler Werke, A.G., founded in 1907, sustained rather severe damage during World War II and was not completely rebuilt and operative until the early 1950's. Its total sales in 1951 were $700,000. The economic recovery of Western Europe and of West Germany in particular, is historic. The growth of P.W.A.G. has paralleled this trend, and in 1960 its shipments reached $6.5 million. There have been three major plant expansion programs during this ten-year period, for which the entire capital outlay was financed locally. The parent company's contribution to this recovery was technical assistance in the form of ceramic research and engineering know-how, plus management direction and guidance. While there has been *no* outflow of dollars, a substantial flow of income has been remitted to the United States in the form of license commissions and in dividends. The total income received in the United States in 1951 was $3,000; in 1960 this figure rose to $256,000 and the cumulative total over the ten-year period added up to $1,360,000.

During each of the last four years, virtually the entire net income of the German company has been distributed in dividends; part in cash and part in stock. In Germany, cash dividends are declared as a percentage of fixed capital, and large percentage distributions are looked upon with disfavor by local authorities. The purpose of the stock dividends was to increase the capital account of the company, which will, of course, enlarge the base upon which future cash dividends can be paid.

Great Britain

Another illustration of foreign operations is our British affiliate, Enamelled Metal Products Corp. (1933) Ltd. Our entire capital investment was limited to $138,000, made back in 1933, for which we received a 50 per cent ownership interest. At that time, we entered into an agreement to provide technical information in return for a license commission based on shipments. Since then we have received license commissions and dividends which in the last ten-year period alone, totalled approximately $550,000.

For the future, we expect to continue furnishing technical assistance, and anticipate a continuing flow of income, all of which originated from an investment made only once.

Japan

When we teamed with Kobe Steel Works to form Shinko-Pfaudler Company, Ltd. in Japan in 1954, our contribution was solely in the form of technical know-how. We negotiated a license agreement which provided us a royalty based upon a percentage of shipments, and in addition, a one-third equity in the company.

The growth of this Japanese organization has been even more rapid than that of our German subsidiary. From its origin in 1954, sales rose to $6.6 million in 1960 and are anticipated to total approxi-

ABOUT THE AUTHOR

• WILLIAM G. vonBERG *graduated from Syracuse University, B.S. in Accounting, cum laude and is a CPA (New York State). He has been affiliated with Pfaudler Permutit Inc., Rochester, New York, since 1952, where he successively has held the posts of assistant to the comptroller, 1952-53; assistant comptroller, 1953-56; assistant comptroller and assistant treasurer, 1956-57; and since 1957, company controller. Before joining his present organization, he was controller of W. B. Coon Company, 1948-52, and senior accountant, audit staff, Ernst & Ernst, 1939-42 and again 1945-48, following service in the U.S. Army, 1942-45. He is a member of Controllers Institute; a past president of the Rochester Control; and a member of the Committee on Securities and Exchange Regulations of the Institute. This paper was presented before a group attending the Government-Industry Conference sponsored by MAPI and held in Washington, D. C., in May 1961.*

XUM

mately $10.5 million in 1961. Income received here in the United States in the year 1960 alone was $440,000. Until recently, all expansion of the Japanese company's operations was financed locally. In February 1961, we made our *first* cash contribution to capital in the amount of $150,000, to be used toward a major expansion of plant facilities, currently under way. Income sent to the United States in 1961 is expected to be approximately $550,000.

South America

In 1955 we recognized the longer-range potential developing to the south—in Central and South America.

As a first step toward capitalizing on these markets, we established Pfaudler Development Corporation in 1956, a wholly owned subsidiary in Panama. Shortly thereafter, this company purchased an 85 per cent ownership, and in 1959 the remaining 15 per cent, of a steel fabricating company in Mexico City. The total investment in this company, now known as Pfaudler Permutit, S.A. de C.V., was approximately $500,000.

Although the return has to date been modest, it has been accumulated by the Panamanian corporation to be used in our plan for further foreign investment. This program was implemented late in 1960 when these accumulated funds were used to establish a Brazilian subsidiary in Sao Paulo, to accelerate our efforts in promoting Permutit products in the Brazilian market.

Canada

Pfaudler Permutit Canada Limited, our wholly owned Canadian subsidiary acquired in 1959, is a new enterprise, and not yet a profitable one. It is our objective to broaden the market position of this subsidiary by introducing the manufacture of some of our domestic products, to add to the Canadian company's volume and improve its profitability.

Coordination and direction of these operations abroad are centered in an International Division headquarters located in Rochester, N. Y. We do not believe we have reached the zenith of foreign activities and are currently reviewing the market potential in other areas, notably India and Australia.

SOME PROS AND CONS ON FOREIGN INVESTMENTS

Now let me discuss some of the common misconceptions which have been written and spoken by those who have not had the practical advantage of conducting actual operations abroad.

It has been stated that tax deferral on income earned abroad through the use of "tax haven" countries constitutes an indefinite postponement of the United States income tax.

Our company is a United States enterprise, and all its shareholders, with a few exceptions, reside in the United States. As a professional management group, the sum of whose stockholdings constitutes only a minor portion of the total, our main interest lies in serving the best interest of those who own the company.

Consistent with the best interest of domestic shareholders is our objective of producing income *in the United States.* Our only incentive for investing abroad is to generate earnings which can be remitted back home. Therefore, the purpose of accumulating income from Mexican sources in a Panamanian company is to have more funds with which to expand in South America. Our desire to invest in South America is solely for the purpose of generating additional earnings which can ultimately be returned to the United States. *How could we achieve the fulfillment of our obligations to our shareowners if the return of income earned abroad were subject to "indefinite postponement"? What good would it do our company, or any United States corporation, to accumulate substantial assets resulting from unrepatriated earnings, in Panama, Liberia, or Liechtenstein, if these assets were to be frozen in any of those lands?* It is inconceivable that the desire to escape the United States income tax could reach such unrealistic proportions.

It has been proposed that the United States income tax be levied against American corporations on their current share of the undistributed profits in any year by subsidiary corporations organized in economically advanced countries.

To begin with, levying a tax on one corporate entity for its share of the undistributed earnings of another seems to be a novel, if not a rather unfair, approach. Second, a formula to arrive at the definition of an "economically advanced" country would be difficult and even hazardous. Imagine attempting to achieve unanimity of opinion not only as to the current status, but on the future status of all nations, as economic conditions change. *What would be the effect on our relations with other nations of our endeavor to rate all the countries throughout the world? What might be the reaction from those who fall into the "economically unadvanced" category?*

Those who favor this proposal apparently define an incentive differently from those nations which have offered a period of tax forgiveness as motivation to outsiders to come in and establish a branch or subsidiary to start up a new industry in their country. The enactment of this proposal would, of course, negate any incentive through tax forgiveness currently allowed by foreign countries. I venture the supposition that the enactment of this legislation would result in the upward revision of the tax rate on subsidiaries of United States corporations by many foreign countries to a level approximating 52 per cent. Furthermore, it seems obvious that subsidiaries of United States corporations, operating in countries whose

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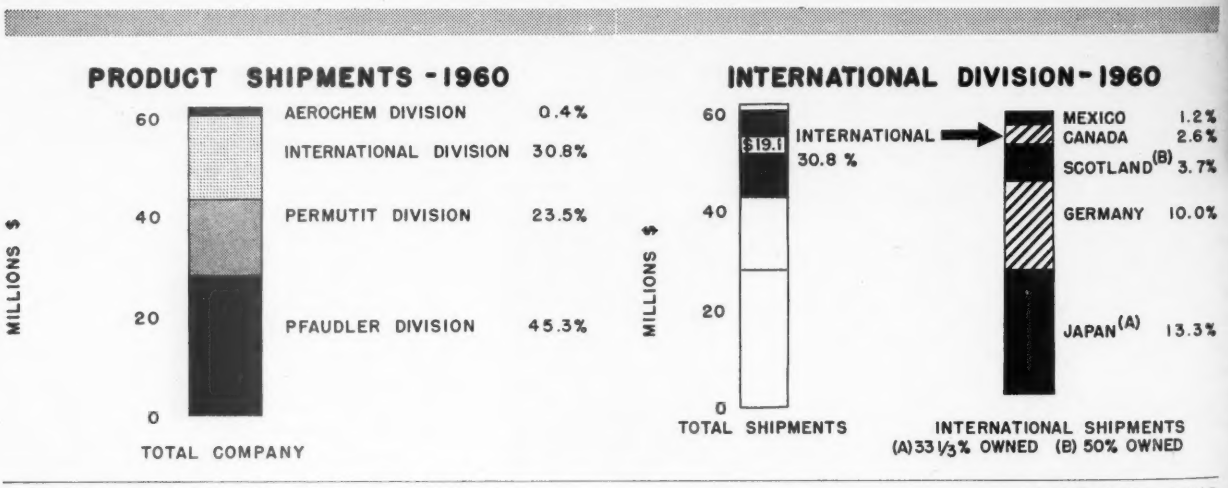
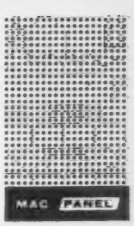


...BY THE POUND

at's a control panel up there on the scales. The way ne panels are sold, you'd think they sold them by the nd. Our panels are lightweight. Sure, but we don't sell m by the pound. We don't set a price and then build n to it. Never. Our experience in the field (we're tab n at heart) tells us how much time, effort and quality uld go into every control panel and component we ke. That goes double when we're planning new prod-s, too. It's happening all the time. If a new product l make your EDP installation work more efficiently, 're for it. And usually the first to produce it. We're proud of our reputation. Quality. Service. Ideas. Sure, our prices are competitive. Have to be these days. But we're going to make sure our reputation for proven dependability and the efficiency of your operation don't suffer in the scramble. How? Ask the tab men who use and rely on MAC Panel products day in, day out. Nights, too. They'll tell you the reason is that the people at MAC Panel know the problems and understand the procedures of an EDP installation. We'll tell you our only business is making panels. The best panels. Your MAC Panel representative will tell you more. Weigh the facts yourself.



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epresentatives throughout the United States, in Canada, Latin America and in Europe

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tax rate is less than that of the United States, would immediately be put at a competitive disadvantage locally, not only with nationals, but also with subsidiaries of British, West German and other firms whose parent companies are not subject to this tax treatment.

Not to be overlooked is the cash flow problem presented to American parent corporations of foreign subsidiaries. In our own case, for example, earnings of most of our foreign companies are remitted to us as rapidly and in as large amounts as good business practice will permit. These are, of course, subject to United States income tax. *From whence would we, or any other United States parent corporation, obtain the cash to pay the United States tax on undistributed earnings which are left abroad and reinvested in the expansion and growth of the subsidiaries?*

Elimination of the existing method of computing the foreign tax credit has been proposed, and in its place, the so-called "gross-up" method has been offered.

What would be the reaction to this upon the part of those nations with whom we have negotiated tax treaties and conventions? The direct effect on our company would be a substantial reduction in earnings from abroad. The result of enacting this proposal would surely be a lessening of interest or even willingness on the part of American industry to invest abroad. The expropriation of American industry in Cuba; the growing philosophy south of the border toward "Mexicanization" of industry; the recent expression of feeling toward greater nationalization in Canada; and the unfriendly attitude of many governments toward foreigners, particularly Yankee, all require that no additional obstacles be placed in the path of American industry abroad.

Objections to foreign investments have come from certain quarters suggesting that funds invested abroad reduce the availability of funds for capital investment in the United States.

Our own situation shows that the reverse is true; that investments abroad have yielded income which has increased the funds we have available, not only for domestic capital investment but also for expanded research effort which is carried on in the United States. Further, as our products have gained acceptance throughout the world, our sales to subsidiaries and affiliates, of frit (a basic material compound used in the manufacture of our ceramic coating material) as well as certain parts and components, have increased. Our exports of United States-manufactured goods have also increased, due to the inability of our foreign plants to supply certain needed equipment, either as a result of delivery schedules or particularly severe specifications which can only be provided from our domestic plants. In 1960, our total exports of products, parts and supplies rose to approximately $5 million.

To summarize our company's experience with foreign investments, we have during the last seven years invested abroad approximately $1.2 million. Total income received here in the United States from our foreign investments during the same period was just slightly under $3 million. I might repeat that whereas an investment is made only once, the income derived therefrom is continuous.

To reflect more accurately the full impact on the United States balance of payments, I should add that the dollar value of exports from our United States plants for shipment abroad, during the last seven years, was approximately $25 million. Thus, total dollar inflow achieved by our company alone, during this period has reached the sum of $28 million, versus a total dollar outflow of $1.2 million.

It is vital for our nation to take part in and to capitalize upon the expanding world markets of today. The reasons are many. I have, however, limited myself to a case history of our company's foreign operations as they affect private investment abroad and the United States balance of payments. I have not even attempted to discuss economic expansion abroad as the basis of maintaining our nation's position of political leadership.

Suffice it to say that in competition with foreign manufacturers, United States enterprise is outpriced in the world market place, except as to products which we can make that are new and different. Our salvation is innovation. This requires research time, ingenuity and money to create new products, thus stimulating new demands. Only with this approach can we hope to maintain the high economic level we currently enjoy.

In today's highly competitive global economy, one of the objectives of our Government should be to foster and promote participation on the part of private investors in world trade. In our company, we need income from abroad. In the past, such income has sponsored much of our research. Its continuance is vital to our expansion of future research. On a nationwide basis, this could only strengthen our world position with respect to balance of payments.

It might not be entirely accurate to say that the proposed tax treatment of United States companies' foreign operations would be analogous to "killing the goose that laid the golden egg," but it would certainly cripple the creature.

U.S. INVESTMENTS ABROAD

Direct investments abroad by United States private investors totaled a record $32.7 billion at the end of 1960, nearly three times the $11.8 billion of a decade ago. Seized investments in Cuba are included in this total, but even if these are omitted, 1960 was still a record year.

Fifty-four per cent of all United States investments abroad are in Canada and Europe. Investments in Canada, which accounted for more than one third of the total, more than tripled in the last decade, jumping from $3.6 billion in 1950 to $11.2 billion in 1960. After Canada, the largest United States investments at the end of 1960 were in the United Kingdom ($3.2 billion) and Venezuela ($2.6 billion).

In Europe, United States investments leaped from $1.7 billion to $6.6 billion in the last decade. While the dollar total also rose in Latin America, from $4.4 billion in 1950 to $8.4 billion in 1960, that area's share of the total declined from 38 per cent to 26 per cent in the ten-year span.

Petroleum and manufacturing continued to account for the major share of United States foreign investments, increasing from 61 per cent to 67 per cent from 1950 to 1960.

RELATED READING from THE CONTROLLER

FOREIGN OPERATIONS AND THE CONTROLLER, Swingle, Waymire, Lanterman, Olerich (panel discussion), June 1954.

LONG-TERM EXPORT FINANCING, Ragnar W. Anderson, November 1955.

DOING BUSINESS ABROAD, Paul F. Swantee, June 1956.

PROBLEMS INVOLVED IN QUALIFYING AS A WESTERN HEMISPHERE TRADE CORPORATION, Philmore H. Friedman, March 1959.

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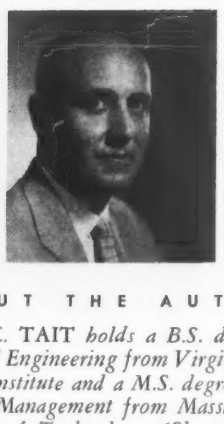


ABOUT THE AUTHOR

• LEE C. TAIT *holds a B.S. degree in Electrical Engineering from Virginia Polytechnic Institute and a M.S. degree in Industrial Management from Massachusetts Institute of Technology (Sloan Fellowship). Prior to becoming comptroller of the Chesapeake & Potomac Telephone Company of West Virginia, Charleston, West Virginia, his telephone career included such assignments as division commercial manager at Richmond, Virginia; staff assistant on the executive staff of the AT&T Co. in New York; and general operations supervisor on the headquarters staff of the Chesapeake and Potomac Telephone Companies in Washington, D. C. He is a member of Controllers Institute of America and is director of Communications of the Southern West Virginia Chapter of the National Association of Accountants.*

INITIALLY, what we might term modern regulation concerns itself with insuring that service would be available to all parties without favor or discrimination. This principle, in fact, is the reason for the term "common carrier" which we hear applied to the railroads, the airlines, the telephone companies, etc. Early regulation in most cases was a direct result of the changes in the economic outlook resulting from new technology. Early government interest was shown through the granting of favors, such as exclusive franchises and land, and then through requiring the industry to take any and all requests for service without discrimination. Only later did the question of rates assume the importance that it does today.

This consideration of uniform service as a prime purpose of regulation is still evident today. For example, utilities do not have the legal right to go out of business without permission of some regulatory agency. Or another example, the Rural Electrification Administration is an instance of government influence concerned with service first, cost later. And in the case of the newest major utility, the airlines, little is heard about rate levels, but much is heard about routes and schedules and safety.

FRANCHISES

Now many of our public utilities such as the railroads, electric power companies and telephone companies, require very high fixed capital investment. This high fixed capital investment means that direct competition—duplication of plant investment—is economically inefficient. It would adversely affect both service and price. So through the granting of franchises, the various governments legally condoned and enforced monopoly conditions for these industries.

It is not difficult to guess what happened next. With monopoly comes power and early in the history of our public utilities, the public began to feel, often with proper reason, that the utilities were taking advantage of their monopoly position to offer rebates, discriminate among customers and charge excessive rates. So the governments sought to establish the power to control the rates that such privileged monopolies charged. They succeeded. More than this, they established the right to regulate the price of almost any business which was affected with the public interest.

At first this power to regulate seemed to be unlimited, that is, there was no protection for the investors. Economic forces reacted to this condition. For example, railroad securities declined remarkably in value. Over a period of time, other court cases followed in which the court said the corporation could not be deprived of due process of law by being regulated. In other words, the corporation was assured of a fair and open hearing and protection against confiscation of property.

Of course, these rulings and subsequent rulings have not finally settled the arguments as to *how* the commissions should determine prices. Much of the argument over the years has centered around the means for determining the value of the plant of a regulated industry as a basis upon which to set prices which allow industry to recover costs and earn a "fair" profit.

If one has a house which he wishes to rent or sell, he may ask for an informal appraisal of the value of the house. This value is based upon the price being paid for comparable real estate in the same locality. This comparable sales approach will not work for a public utility, because there are not enough sales to establish a market. Furthermore, even if there were such a market for utilities, we come up against a second objection. When one sells a business, the prospective purchaser, in establishing the price he is willing to pay, takes as one of his primary bench marks the capitalization or present value of expected future earnings of the business.

Obviously, this will not work in regulating a public utility, because what the regulatory agency is seeking to establish is the proper level of future earnings and, of course, this approach would involve circular reasoning.

In the early days of regulation, the determination of value of the plant of the public utilities was further complicated by a general public suspicion of the accuracy and honesty of corporate bookkeeping practices. Over the years, the commissions have become quite explicit in laying down the regulations for accounting practices so that this suspicion is no longer so widespread among the public and practically nonexistent among regulatory authorities. But another problem which has been with us over the years, that I suspect will be with us for many years more, is the problem which has centered around fluctuation of general price levels.

VALUE

The commissions have been and are seeking a substitute for competition and this is easier said than done. In a competitive market, we define value as the price a willing buyer would pay a willing seller in a free market. Under monopolistic conditions, there appears to be no easy way to arrive at this figure.

One way which might suggest itself is cost of reproducing the *service*—which presumably would be the minimum price at which a new supplier could enter the

field. But once again, this is too conjectural to be of much value. *Who can determine what it would cost to reproduce the telephone service in the State of West Virginia, for example?* Different types of equipment in different locations with different associated operating expenses would be involved.

The courts and the commissions have turned to the rate base times rate of return approach and have defined fair rate of return several ways:

1. A rate of return comparable to that received by other businesses having corresponding risks in the same geographical area.
2. The cost of capital—an amount adequate to attract the necessary capital for expansion and modernization.
3. An amount sufficient to maintain the financial integrity of the business.

REGULATED INDUSTRIES

Now, all of us know *what* industries are regulated, but *why* they are regulated may be worth a few words. While there are many and varied reasons, the following conditions seem to be present in every regulated industry:

1. A very high fixed investment—for many companies, as high as four to six times annual revenues.
2. A large portion of this investment does not vary directly with the number of customers, but tends to be somewhat constant for a given geographical area.
3. The investment would tend to be twice as high if two companies were serving the same area, but they would have no more customers. In fact, there would be fewer customers since the rates would have to be higher to carry the higher investment.
4. There is a need for interconnection such as in transportation and communications.
5. The need for large financial resources.
6. Another common characteristic is that the product is relatively essential to the public.

It should be pointed out that the economic function performed by the company is not necessarily important. For example, transportation is an economic function but the fact that private transportation, in the form of individual or company-owned cars and trucks, competes with all the regulated forms has had very little effect on our view of regulation. Nor has the fact that oil and coal, both generally not regulated, can compete with gas and electricity—or that these two compete with each other in many ways.

And one final word while we are defining public utilities—this has to do with the proportionate part of our total corporate industry which is represented by utilities. Utilities account for 23 per cent of total investment, 37 per cent of depreciable capital assets and 24 per cent of the share owners.

The development of an independent regulatory agency as we know it is uniquely American, although the idea of price controls by governments is not, of course, and in fact, English common law has been cited by our own jurists in support of their findings as to power of the government to regulate.

RATE SCHEDULES

How does regulation actually take place? What are the specific techniques of applying the theory that has been worked out by legislation and legal interpretation? There are many aspects to regulation, of course—the granting of certificates, investigation of service criticisms, etc. The phase we are discussing deals with the authorization of a new rate schedule. This most often begins upon application by a company for a higher schedule, although it may be initiated by the commission or by a third party. First, let's sketch the broad outline. A rate base and a fair rate of return will be determined. The two will be multiplied to obtain authorized net earnings for the test period selected for the case. The next step is to compare these earnings with the actual net earnings during the test period. This will give the net increase needed to realize the fair rate of return. To this will be added the corporate income tax on this additional net, producing the gross revenue increase required. This will then be apportioned to the various services offered by the company in a manner suitable to the commission.

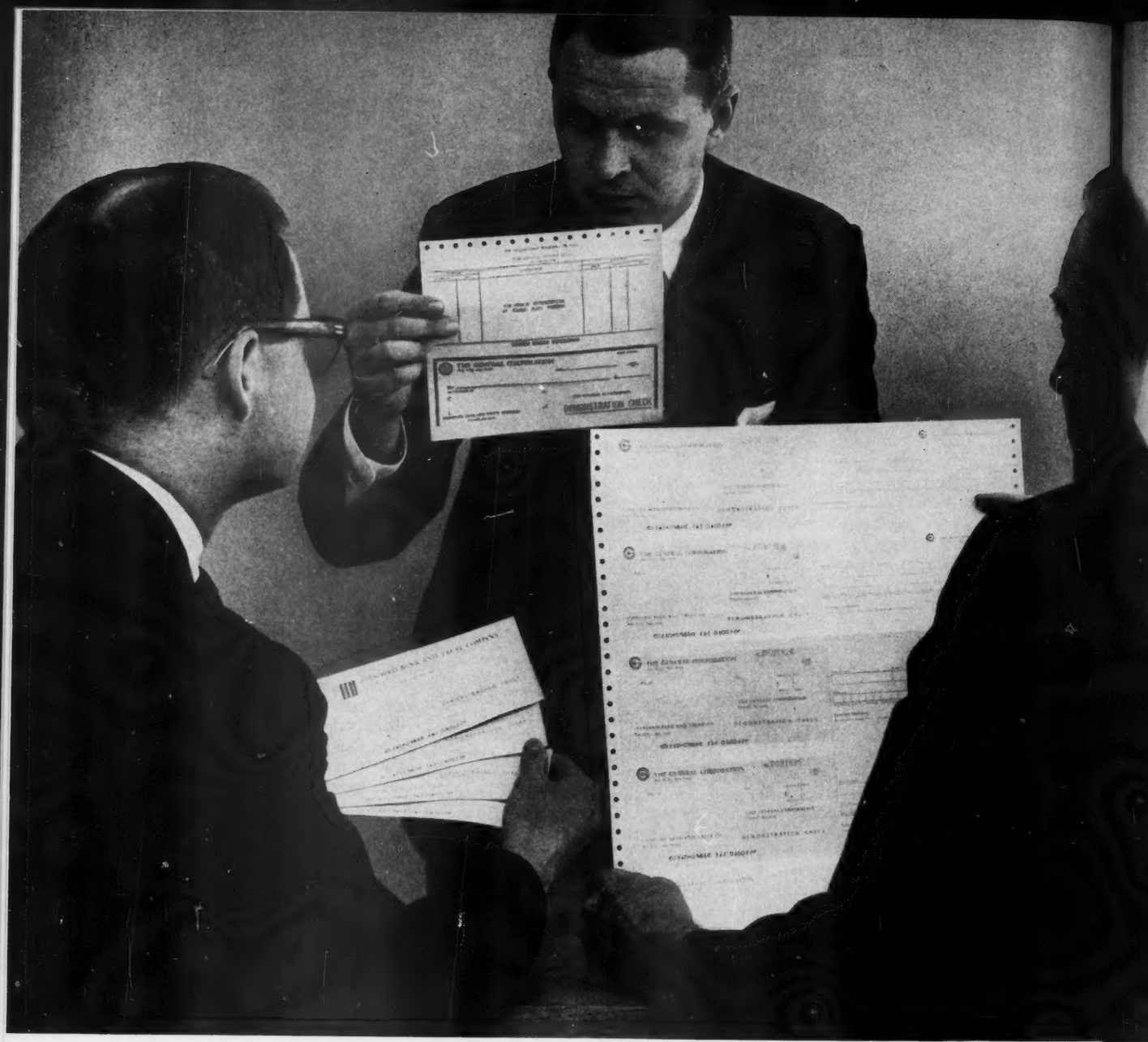
The first basic problem is whether to use original cost, trended original cost, or reproduction cost rate base. In the inflationary times in which we live, original cost will exert a downward pressure on the rate base and reproduction cost an upward pressure. This decision will be based on the laws of the jurisdiction involved, interpretation of court findings, and the commission's own expert judgment. Obviously, continuing inflation will have a continuing effect—and the longer the economic life of the plant, the greater the effect. It should be pointed out that inflation is an *uncontrollable* element in revenue requirements, almost completely out of the hands of both commission and company.

Original cost is a strict accounting record of capital expenditures. Reproduction cost of existing plant is an engineering-type approach. A trended original cost, giving weight to the year-by-year changing purchasing power of the dollar, is an accounting study. A fair value rate base gives recognition in some way to the changing value of the dollar. All these are faulty economics in that they include cost of some obsolete plant.

The "value" of any plant as we all realize, is not what the owner paid for it—but what it is worth to the owner in generating an output of goods or services. In short, in an expanding economy, it is the cost of reproducing the equivalent plant, less depreciation. But with the inflation we have had, this type of rate base is inevitably higher than an original cost base and, hence, is politically unpopular.

(Continued on page 561)

"Oh, nuts—here comes the chief stockholder!"



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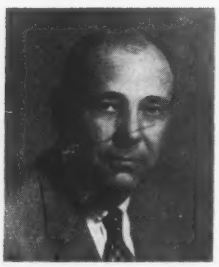
Edward W. Lewis

An Insurance Manager Reports to Management



• EDWARD W. LEWIS, *insurance manager for Richardson-Merrell Inc., New York, tells how to draw up a report that provides the vital information essential to management's over-all view of the company's insurance program. Mr. Lewis was connected with the New York Stock Exchange as an examiner on its staff representing the Exchange in dealing with corporations, particularly in connection with the listing of securities for trading, before he became associated in 1934 with Vick Chemical Company (now known as Richardson-Merrell Inc.) as assistant to the treasurer. He assumed his present post in 1951. Mr. Lewis is a member of the New York Chapter of the American Society of Insurance Management.*

INFORMATION about virtually every facet of the insurance field as it applies to the corporate insurance buyer from the basic ABC's to the extremely complex foreign insurance problems has been published and expounded in seminars. One notable exception, however, appears to be the scarcity of material on the *what* and *how* of insurance reports to management.

Probably the single factor accounting most for the shortage of material on the subject is that relatively few insurance managers are obliged to prepare and submit a formal comprehensive annual report to management. This does not necessarily indicate any lack of interest on management's part, but more likely is an acceptance of the fact that admittedly the annual expenditures for insurance are relatively small in comparison with such major costs of doing business as cost of materials, distribution costs, research costs, marketing costs, etc., and, therefore, often relegated to secondary consideration. However, with the steady increase in the cost of buying proper insurance coverage and the growing awareness of the need for adequate protection, evidenced by the newspaper publicity attendant on sizable property and casualty losses today, we can look for management to manifest a greater interest in the operations of the Insurance Department.

WHAT SHOULD THEY LOOK FOR?

A report sufficient within itself to provide the vital information essential for those responsible to obtain a concise picture of the over-all insurance coverage should contain four primary components as a minimum:

1. Classes of Insurance Carried

Three major classifications immediately present themselves, i.e., those pertaining to loss of property, loss of earnings, and finally, third party liabilities.

Loss of property concerns itself with such insurance as fire and allied lines, boiler, and crime coverage which affords protection to buildings, equipment, inventories, money and securities.

Loss of earnings, as its name implies, relates to those losses sustainable through interruption of operations where any of the perils insured against are invoked. Fire and boiler business interruption are the coverages generally involved.

Finally, the *third party liability* insurances. These readily fall into two categories, those affecting employes (workmen's compensation, travel insurance, etc.) and those affecting the general public (automobile, products, advertisers' legal liability, etc.).

In each instance, both the subject for insurance and the hazard insured should be clearly delineated.

2. Amount of Each Class in Force

Where coverages are purchased "across the board" and apply equally to all property and/or persons, no problem arises in reflecting the specific limits carried. However, where individual limits prevail, as frequently is true in the case of fire insurance applying to separate plant properties, care should be taken to itemize these in detail by organizational unit to enable proper comparative appraisal.

3. Annual Cost

This is probably the most difficult to tie down because of the variety of ways in which insurance is purchased and the changes in coverage that take place during any given year. One method we have used successfully is to present an estimated annual cost. Where a deposit premium is exacted, subject to audit some time after the close of the fiscal period, that deposit premium alone is used. Where insurance is purchased on a three- or a five-year basis and the premium remains unchanged during the entire period, one third or one fifth respectively is inserted. On the other hand, where interim changes occur either in the limits carried or in the applicable rates, particularly with fire coverage, the estimated annual cost is based upon the limit and rate in force at the close of the fiscal period under review. Retrospective rating adjustments during any year are not included in these estimated cost figures. They receive special treatment in the report by way of an exhibit which compares the retrospective results with those under a guaranteed cost basis for at least a five-year period reflecting the most current audited figures available. Patently, then, only certain of these totals will coincide with the accounting records of the company, but consistently used, they provide comparable measures for evaluating results.

4. Current Loss Record

Since the loss experience is a key factor in insurance costs, especially where retrospective rating plans are employed, no comprehensive report would be complete without a digest of claim settlements. Here again, though, we run into a certain amount of difficulty in presentation.

Claim settlements for property damage losses present no real problem because the report need only reflect the actual payments received in the reviewed year irrespective of when the loss occurred.

In the case of casualty losses, as is well known, the complete 12-month results are normally not available until long after the year closes. To us it seems preferable to not delay reporting so long as a satisfactory comparable substitute exists. Thus, casualty losses are shown for the complete nine-month period only. As a means of

(Continued on page 546)

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improving the picture, however, and making evaluation somewhat more realistic, the reserves established on unsettled claims for the same period are likewise included in the summary.

TELLING THE STORY

Statistical information, as suggested above, tells a large part of the story and is most significant when presented on a comparative basis. But to achieve a better understanding of the entire insurance picture, it is desirable to supplement this data with detailed comment, especially emphasizing the pertinent situations having the greatest influence on the over-all annual results.

It has been found that two primary categories of comment contribute most to the interpretive value of these reports from the standpoint of management:

The *first* deals with a full discussion of the coverages and cost with extra attention devoted to salient changes during the year reviewed, as compared with the prior period(s). In this cost-conscious era, too much stress cannot be concentrated on analyzing the premium expenditures, particularly where extraordinary increases or decreases have occurred.

The *second,* and equally important, covers the comments on noteworthy highlights during the period under review. It serves the dual purpose of enabling the insurance manager to recount his achievements while at the same time providing management with vital material with which to properly judge the adequacy of the company's insurance program. The subjects for discussion are manifold, but must, of necessity, be tailor-made to fit each individual requirement. One favorite topic always contained in this section of the report is a thorough review of the loss experience.

Up to this point, the prime objective of the report has been to present a complete picture of the past with only occasional reference to the future. Undoubtedly, management also wants to know what is envisioned for the ensuing year and the report serves as an ideal vehicle for responding to this query. An entire section of the report is devoted to outlining plans, recommendations, etc., with the choice of subjects running the gamut from a recital of currently unresolved problems and their proposed solution to recommended treatment of anticipated problems and quickly reveals the forward thinking ability of the individual reporting.

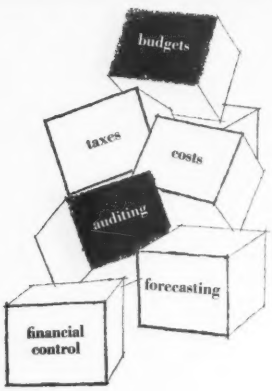
DISSEMINATION OF REPORT

Throughout the text, we have referred to "management." Just how this relates to individual companies is largely a matter of corporate organization and the general policy of insurance administration under which each functions. Suffice it to say, the variations are limitless and no categorical procedure for disseminating such a report can be offered.

Under the circumstances, it is perhaps safer to resort to a personal application by way of illustrating the extent of distribution that can be accomplished. Copies of the writer's complete annual insurance report (which includes individual divisional reports) are prepared for the president and the Insurance Committee, of which the vice president for finance is chairman. The report is also reviewed by the Finance Committee.

Since each general manager of the various divisions is directly charged with the responsibility for insurance in his bailiwick, an individual statistical report, using the four components cited earlier, is prepared for him at the close of each fiscal year with a covering review of matters pertaining to his particular division.

Thus, this latter arrangement provides, at least once each year, all the ingredients necessary for a local audit of that portion of the company's insurance program which is applicable to the individual division with the concomitant benefits that can and do result.



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USE AND OCCUPANCY AND EXTRA EXPENSE INSURANCE, Marshall B. Dalton, February 1952.

AN INSURANCE PROGRAM FOR AN OPERATING COMPANY, William R. Walker, November 1952.

CHANGING CONCEPT OF CASUALTY INSURANCE, Harold W. Horton, January 1954.

INSURANCE PROTECTION FOR CAPITAL ASSETS, A Report, September 1959.

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Don Nigro (right), Pratt & Whitney Aircraft Master Mechanic, shows Mobil Field Engineer Bill Allman how the computer system automatically schedules most efficient maintenance by printing instruction cards for each machine.

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Daily machine maintenance activity is collected in the form of punched paper tape. From the tape is maintained a complete maintenance history record for each machine which includes down time, repair costs (labor and material) and a complete description of work done. The repair history and machine condition reports which are coded and shown on the master record are used for considerations of machine application, overhaul or replacement. Runoffs by machine type and department are used to point up problem areas so that the best thinking of both maintenance supervision and operating supervision can be brought to bear. In addition, reports are compiled on starting and completion dates, work backlogs in hours, employee records and departmental performance.

How Mobil Helped

For many months Mobil's technical staff worked with P&WA production engineers to standardize and simplify machine lubrication and hydraulic system procedures. For each piece of equipment, a master card was prepared listing parts to be lubricated, lubricant used, frequency of re-application, system changes, filter changes and personnel responsibility.

The complexities of analyzing the lubricant recommendations of the 400 manufacturers were simplified by Mobil contacts with these builders. As a result, the number of lubricants was reduced from 44 to 18 with the builders' approval. This was far more complicated than the usual "survey," involving frequency, coding, inspection and preventive maintenance. Concrete recommendations were made by Mobil in these areas. With this specific information on hand, P&WA programmed these factors into the data processing control system. In setting up the system, the goals were:

1 *To establish an accurate control of work arrangements to facilitate scheduling, to establish completion times.*

2 *To reduce unscheduled down time and machine part replacement costs from lack of adequate lubricants.*

3 *To develop accurate follow-up information regarding correct use of predetermined lubricants, proper frequencies maintained, adequacy of filter and lubricant change periods.*

4 *To spotlight chronic leakers or high lubricant make-up units.*

5 *To spotlight high maintenance cost units.*

6 *To identify need for machine design improvements as determined by specific local uses.*

As a result of careful planning and intimate knowledge of all machine requirements, an automatic system of inspection, lubrication and maintenance was set up. Mobil preventive maintenance methods were adopted for all hydraulic and circulating systems. Inspections indicated the need for filtering circulating oils in place every six months. Automatic lubricators were installed where applicable to reduce the more frequent application periods and to conserve lubrication personnel time. Troublesome systems were carefully cleaned using special Mobil flushing techniques.

Clinics were conducted for maintenance, repair and other personnel. Special devices were used to permit quick connection of couplings to portable filters; high-volume pumps reduced time in changing reservoirs; improved grease-gun loading equipment was adopted. A definite leakage control program was adopted to balance lubricant cost against leakage. Steps were also taken to correct individual problems that consume excessive personnel time.

The system works. Today, three years later, the impressive benefits on the opposite page have been chalked up. The reduction in maintenance costs over this period totals several hundred thousands of dollars.

Three important conclusions can be drawn from this work:

1 The outstanding success of this achievement reflects the progressive Pratt & Whitney attitude that has led to distinguished accomplishment in many technical fields.

2 Mobil, with the largest and most experienced technical lubrication staff, is best equipped with the engineering manpower necessary to help customers do this kind of a pioneering job.

3 Properly programmed, data processing control offers tremendous possibilities for cost reduction in industrial lubrication and maintenance.

IF YOU HAVE COMPUTER TIME AVAILABLE... AND A PLANT OR FLEET THAT COSTS TOO MUCH FOR MAINTENANCE... IT WILL PAY YOU TO CONSULT MOBIL.

XUM

G. Kibby Munson

Roberts & McInnis, Washington, D. C.

An Income Tax Whodunit

Interesting detective stories are not limited to the popular whodunits. Sometimes the efforts expended in proving up a tax case in real life will involve a detective story that is as fascinating as any to be found in fiction. A case in point was the tax case decided by the United States Court of Claims in the *Texas City Terminal Railway Company* v. *the United States* on June 5, 1957, reported in 152 Fed. Supp. 227. The Court decision recites the story of a corporate reorganization, out of which a new railroad company emerged in January of 1921. How the 40-year-old facts were obtained and proved is the subject of this article.

THE PROBLEM was to prove that the holders of the equity in the predecessor corporation were also the holders of the equity in the successor corporation after the termination of bankruptcy proceedings and the acquisition of the assets of the bankrupt by the newly organized successor corporation. In that event the successor corporation, the Texas City Terminal Railway Company, would be entitled, under the applicable provisions of the Internal Revenue Code, to use the cost basis of its predecessor for that corporation's property acquired in the reorganization, instead of a direct cost basis less than half as great.

The task at first appeared to be impossible, because most of the records of the Texas City Terminal Railway Company, including such records as it had acquired from its bankrupt predecessor, had been destroyed by the explosion and fire at Texas City, Texas, in 1947. In addition, most of the individuals who were intimately connected with the predecessor and with the organization of the Texas City Terminal Railway Company, including Augustus Peabody who had been most active in the whole matter, were dead. The Houston attorney who handled the 1920 bankruptcy proceedings in the court at Galveston was dead and none of his files could be found. The bank in Chicago which had been trustee under the mortgage of the predecessor corporation had been liquidated in the 1930's and its records could not be located. The Chicago investment banking partnership of Peabody, Houghteling & Co., which had financed the predecessor corporation and had sold its securities, was liquidated in the early 1920's and its records were gone. Finally, the Interstate Commerce Commission, in authorizing the issuance of securities by the Texas City Terminal Railway Company in July 1921 (70 I.C.C. 244), had made a mistake in its recital of the securities of the predecessor, which, if true, would have made impossible any proof that a tax-free reorganization had taken place.

The predecessor corporation was the Texas City Transportation Company, which had owned a line of railroad extending from Texas City, Texas, to connections with four trunk line railroads. Its railroad, which had been acquired from a prior owner in 1904, was leased to a wholly owned subsidiary for operation. On November 1, 1909 it had issued $2 million of serial mortgage bonds, but traffic had fallen off due to the diversion of traffic during World War I, and it had paid no interest and had met no serial maturities beginning with the November 1, 1915 payment date. In 1920, bankruptcy proceedings were filed in the District Court of Galveston County, Texas.

The railroad properties of the predecessor corporation were sold at a bankruptcy sale in August 1920, to an individual named Augustus Peabody, representing Peabody, Houghteling & Co., the investment bankers who had sold the 1909 bond issue and had financed the railroad and the first lien mortgage bondholders. His bid, in substance, was $50,000 cash subject to the first lien mortgage bonds and accrued interest. Thereafter, early in 1921, he transferred those assets to the taxpayer, the Texas City Terminal Railway Company, in exchange for all its common stock, except directors' qualifying shares. At the same time the Texas City Terminal Railway Company issued its first mortgage bonds in a face amount equal to the face amount plus accrued interest of the predecessor's first lien mortgage bonds, in exchange therefor.

The years involved in the tax case were 1945 and 1946. However, the explosion and fire at Texas City in 1947, which had destroyed most of the company's records, had also destroyed most of the company's property located at Texas City. To the extent that property destroyed had been acquired from the predecessor corporation in the 1920-21 reorganization, certain income tax liabilities for 1947 would be controlled by the 1945 and 1946 case.

Back in 1921 the taxpayer, the Texas City Terminal Railway Company, entered the property which it had acquired through the bankruptcy proceeding on its books at its predecessor's cost of $5,459,285.80, including some minor adjustments. It used that basis in its 1921 tax return, a photostatic copy of which was procured from the Internal Revenue Service. The revenue agent in 1926, in his report for 1921, however, had reduced that figure to $2,547,261.66 as the taxpayer's direct cost of acquiring its railway property, through cash expenditures plus the principal amount of securities issued by the taxpayer. Thus, the Texas City Terminal Railway Company had failed to establish its right to its predecessor's cost basis in its first tax year, 1921, but had not litigated the question. However, for the years 1945 and 1946, the Texas City Terminal Railway Company again sought to use its predecessor's cost basis in refund claims which it filed. Those refund claims were denied by the Commissioner of Internal Revenue upon the same grounds as the 1921 contention had been denied, and the taxpayer then filed suit in the United States Court of Claims just before the Statute of Limitations had run. At that point the attempt to obtain evidence, acceptable in court, reconstructing what had occurred in the years 1915 through 1921, was accelerated.

The first step in the investigation was

to visit the Court House in Galveston, Texas, and to obtain all the formal pleadings in the bankruptcy proceeding involving the predecessor corporation back in 1920. Some of them were missing, but a single paragraph in an amended petition filed in the proceeding disclosed that unnamed holders of certain past-due serial first mortgage bonds and interest coupons had held a second lien position subordinate to the other bondholders under the first mortgage. In other words, they had held the position next junior to the first lien mortgage bondholders but their identities were not disclosed in the pleading.

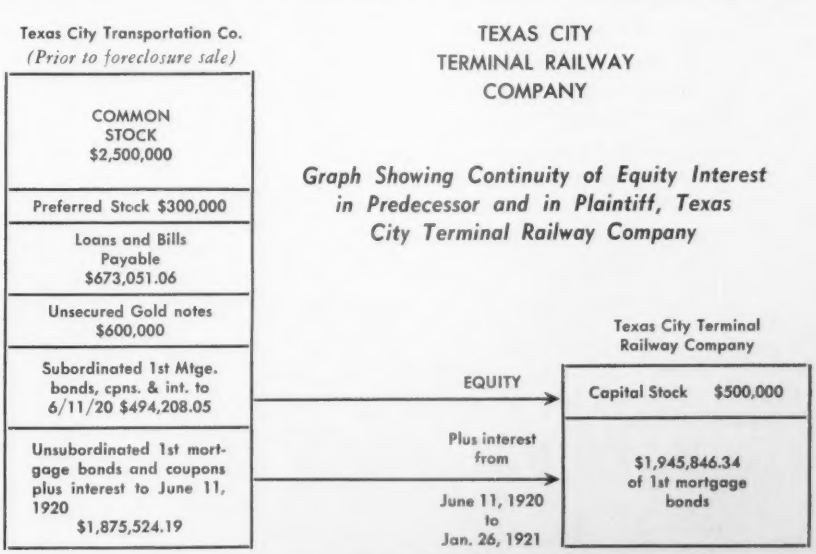
Next, a Chicago office copy of an audit made by Price, Waterhouse & Company of the financial dealings between Peabody, Houghteling & Co. and the Texas City Terminal Railway Company's predecessor covering the period 1912 to 1920, inclusive, was located. That audit showed that Peabody, Houghteling & Co. had bought $150,000 face amount of the serial bonds coming due on November 1, 1915 and November 1, 1916, plus all the interest coupons falling due on five semi-annual interest payment dates, as they were presented for payment, and had then agreed with the predecessor corporation to extend the date of payment thereof. A copy of the mortgage under which those bonds had been issued was located in old warehoused securities issuance files of the Interstate Commerce Commission in Washington, D. C., for the year 1921, and it was observed that the mortgage contained a provision that if any bondholder agreed with the issuer to extend the time of payment of a bond or of interest thereon when due, without the prior written consent of the holders of at least three-quarters of the bonds outstanding, the extended bonds and interest coupons would take a subordinated second lien position under the first mortgage. Thus, by virtue of the time extension without the prior consent of the other bondholders, the bonds and interest coupons acquired by Peabody, Houghteling & Co. when due had taken a second lien position under the first mortgage.

There were still gaps in the proof to be filled in, and questions to be answered. It was learned that a man was still living who had been active as an officer of the predecessor, the Texas City Transportation Company, had participated in the bankruptcy proceedings, and had been an officer and director of the successor, the Texas City Terminal Railway Company, and that he was also a member of Peabody, Houghteling & Co. He had an office in New York and a summer home on Cape Cod. Repeated attempts to see him failed for nearly a year, but in February 1953, he was called upon in his penthouse office reached by a catwalk atop the roof of a New York office building. An interview with him disclosed that he had been in Europe for a considerable period after the United States entered World War I and well into 1920. Consequently what he could testify to was of little or no help. He remembered, however, the name of a man who had been the principal accountant for Peabody, Houghteling & Co. and who had subsequently worked in San Francisco.

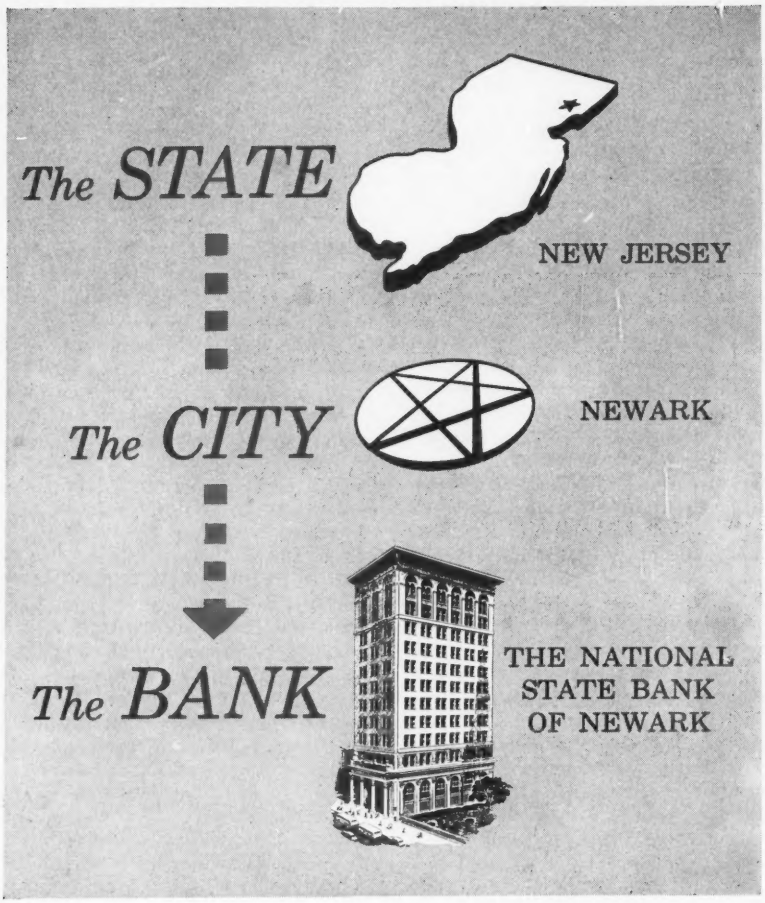
Through the efforts of a San Francisco director of the Atchison, Topeka and Santa Fe Railway Company, a part owner of stock of the taxpayer, the man was located living in retirement near San Francisco. From him it was learned for the first time that prior to and in the early years of World War I the *partnership*, Peabody, Houghteling & Co., had advanced large sums of money to the predecessor corporation, the Texas City Transportation Company, and that by 1918 the partnership needed additional capital. Consequently, the partnership had organized a *corporation* under the same name, Peabody, Houghteling & Co., and had transferred to it the partnership's goodwill and investment banking business. The problem then became one of unraveling and separating the activities and investments of the partnership and of the corporation of the same name, more than 30 years after the creation of the corporation. The problem was not made easier by the fact that the side-by-side existence of two entities, a partnership and a corporation, with identical names, had not been disclosed to the public.

This man also stated that he had been an accountant for the corporate entity but not for the partnership and, consequently, could not testify as to what had happened to the matured bonds and interest coupons which the partnership had acquired from the Texas City Transportation Company and had agreed to subordinate. However, he supplied the names of several men in and around Chicago who, as young men, had had some contact with the partnership of Peabody, Houghteling & Co. Through one of them, a lawyer, who had been attorney for both the partnership and later the corporation, was located in California where he was living in retirement. His testimony was taken before a Commissioner of the Court of Claims in San Francisco. As a result of his testimony and with the help of additional information supplied by a nephew of Augustus Peabody who was living in Washington, D. C., records on file in the Probate Court of the County of Cook, State of Illinois, were located in the matter of the Estate of William R. Stirling, a deceased partner of Peabody, Houghteling & Co., who died in 1918 and whose estate was still being administered through 1921.

Those records, which included inventories of partnership assets and agreements between the Stirling heirs and the remaining partners for their liquidation and distribution or reinvestment, together with records obtained from the First Trust and Savings Bank of Chicago, Illinois, which had acted as administrator of the Estate of William R. Stirling, established that (1) the partnership of Peabody, Houghteling & Co. had retained through the bankruptcy proceeding the subordinated bonds and interest coupons of the predecessor which had acquired a second lien position under the old mortgage; (2) that those second lien obligations had been surrendered for the stock of the taxpayer, the Texas City Terminal Railway Company; (3) that all the stock, except for directors' qualifying shares,


Texas City Transportation Co.
(Prior to foreclosure sale)
COMMON STOCK $2,500,000
Preferred Stock $300,000
Loans and Bills Payable $673,051.06
Unsecured Gold notes $600,000
Subordinated 1st Mtge. bonds, cpns. & int. to 6/11/20 $494,208.05
Unsubordinated 1st mortgage bonds and coupons plus interest to June 11, 1920 $1,875,524.19
TEXAS CITY TERMINAL RAILWAY COMPANY
EQUITY
Plus interest from June 11, 1920 to Jan. 26, 1921
Texas City Terminal Railway Company
Capital Stock $500,000
$1,945,846.34 of 1st mortgage bonds

Graph Showing Continuity of Equity Interest in Predecessor and in Plaintiff, Texas City Terminal Railway Company



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had been issued to Augustus Peabody, a member of the partnership, who had held title thereto for the partners; (4) that that stock had then been transferred to a Canadian corporation, wholly owned by the partnership, which continued to hold title for the partners; and (5) that title to the stock remained in the Canadian corporation (whose name had been changed in the meantime) until the stock of the Texas City Terminal Railway Company was sold in equal shares to three of the four trunk line railroad connections in 1926.

The facts, as gathered, were pieced together and incorporated into a stipulation which was supplemented by some testimony. Additional testimony was given by an accounting witness to the effect that he had allocated to various Interstate Commerce Commission primary accounts portions of the single sum investment figure on the books of the predecessor, with minor adjustments, in the same proportion as that Commission had set up cost of reproduction new among those same primary accounts as of June 30, 1917. That single sum investment figure had been corroborated by reference to a report filed by the predecessor with the Texas Railroad Commission for the period ending August 20, 1920. The amounts thus set up were then adjusted for net annual changes in the property for additions and retirements through the receivership of the predecessor corporation to the date of organization of the Texas City Terminal Railway Company on January 13, 1921, and then down to December 31, 1945, the last day of the year preceding the first of the two years involved in the tax case.

The Court of Claims, on the basis of the facts so obtained and incorporated in a stipulation and developed in some additional testimony, held that the interest of the stockholders of the predecessor corporation and of all creditors junior to the holders of the subordinated second lien bonds and interest coupons had been wiped out through bankruptcy, so that the equity had devolved upon the holder of the subordinated second lien obligations, namely, Peabody, Houghteling & Co., the partnership. The Court further held that since the partnership had obtained the stock of the successor corporation in exchange for those obligations in transferring the predecessor's railroad assets to the taxpayer, a tax-free reorganization had occurred in 1920-21. Therefore, it was held that the Texas City Terminal Railway Company was entitled to use the much higher cost basis of its predecessor for depreciation of the property acquired in the reorganization and as the basis for determining gain or loss upon sale or retirement, as claimed.

Needless to say, this story which took four years to piece together has been considerably simplified in the telling.

XUM

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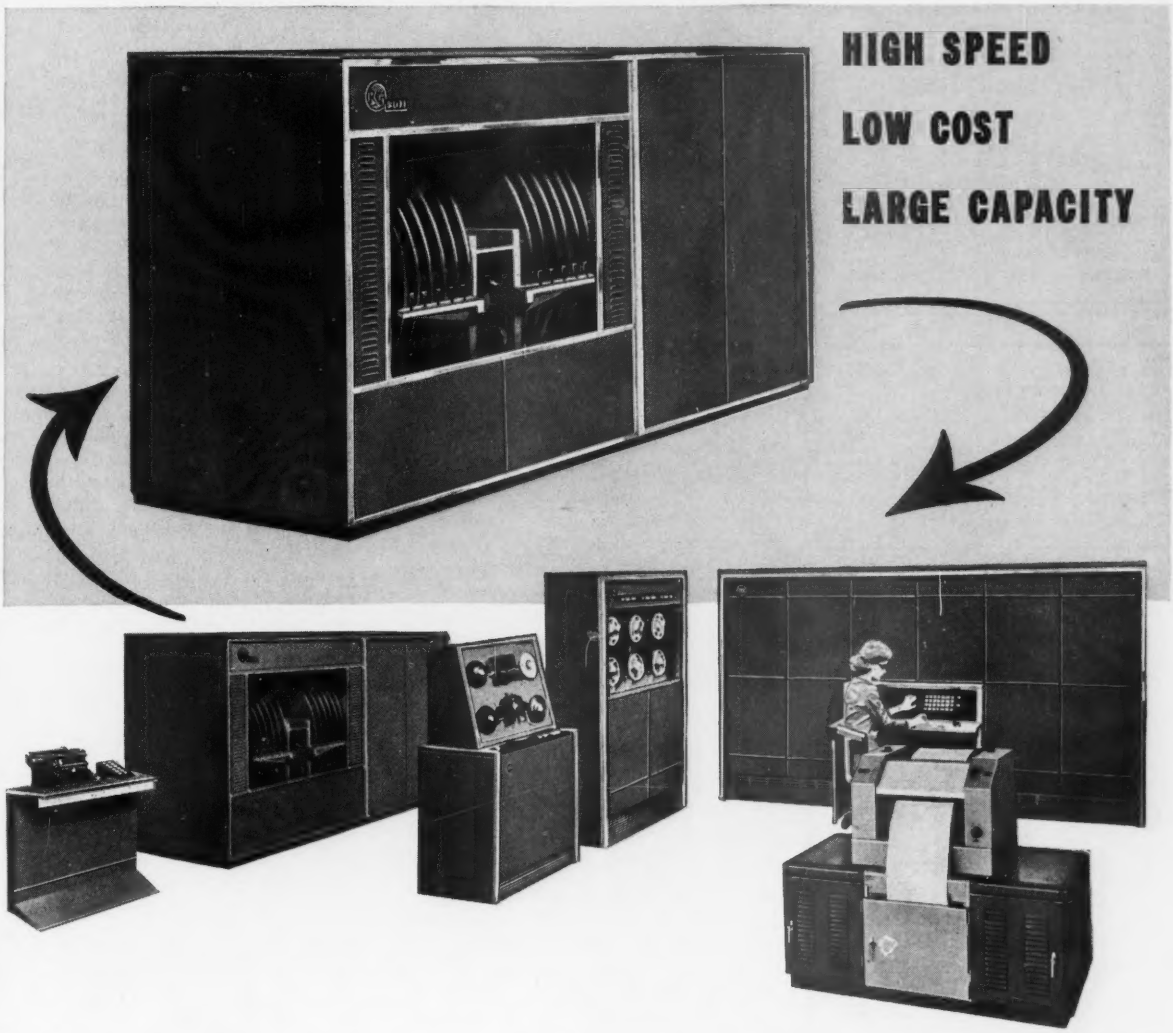

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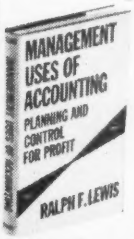

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READING FOR THE FINANCIAL EXECUTIVE

THE IDEOLOGIES OF TAXATION*

By Louis Eisenstein

The first Eisenstein writing to come to my attention was "Some Iconoclastic Reflections on Tax Administration" which appeared in the *Harvard Law Review* for April 1945. The most recent is *The Ideologies of Taxation* some 16 years later. In his choice of titles, Mr. Eisenstein seems to have a predilection for horrible words beginning with "i"!

That is not all these two writings have in common. They are both about taxes, both are cynical—sarcastic is perhaps the correct word—and both clearly and forcefully written. I thought so well of the *Reflections* that I obtained a reprint which is now dog-eared through having been thrust upon numerous colleagues whom I have thought needed a dose of cynicism. It is interesting to note that the term "loopholes" to describe certain anomalies in the tax law was used in the earlier article. By now, thanks to Surrey et al., such use has become quite common, but in 1945 it was unusual.

The book, as might be suspected from its style, is apparently an expansion of lectures delivered at Northwestern University. Its key is contained in the first chapter where the author says: "I have been pursuing the thought that our tax laws reflect the fiscal aspirations of classes or groups." He defines classes or groups. These seem to consist of people who have common economic interests which they assert (e.g., the producers of oil, growers of timber, operators in the Western Hemisphere) and those who are voluntarily given special treatment by the lawmakers (e.g., elderly persons, married people).

The fiscal aspirations of each of these groups, particularly in the area of taxation, are embodied in a form of philosophy designed to justify their active aims or passive benefits. It is apparently much too crude for any group to assert that it wishes to pay less taxes. A philosophy must be established which makes these ends desirable in equity, in the national interest, or for some equally laudable purpose. A great deal of Mr. Eisenstein's book is devoted to an analysis of these claims and assertions and he shows by dozens of examples how absurd most of them are and how they wilt in the bright light of logic. Of course, this type of absurdity is a basic human frailty. It is not confined to the field of taxation. People have a natural inclination to work backwards from what they wish to do to the pious justifications which they finally assert were the reasons for the action in the first place. Furthermore, we can and do unsmilingly produce some appalling non sequiturs in the process. This, I repeat, is not confined to the matter of taxes but can be found, for example, in the justification for dentists' insignia on auto plates. The dentist is a doctor, doctors use auto insignia; therefore dentists should display them. The answer is wrong because the premise—that doctors use them because they are doctors—is wrong. They use them because their cars may be justifiably parked in prohibited places—which is not true of dentists.

The author deals with three major tax-philosophy groups: those whose approach is based on ability to pay the taxes, those who are concerned with the problems (other than pecuniary) caused by a given aspect of taxation, and, finally, those whose view is conditioned primarily by what they choose to describe as equity. Each of these groups is treated with a measure of cynicism which, in view of the examples of their antics, is easy to endorse.

In his—I was about to say attack on—description of the first group the writer quickly leans on Plato, the Founding Fathers, and the 1894 Congress. The last of these imposed a two per cent income tax which was regarded as rankly discriminatory because it granted a $4,000 exemption—which resulted in the exclusion of 98 per cent of the population. In these days it is astonishing to read that this tax was regarded as "communistic in its purposes and tendencies." It is even startling to know that communism was regarded as reprehensible before the October Revolution. This matter of the $4,000 exemption, however, was actually more a problem of equity than of ability. No one seemed to question the ability of those with over $4,000 to pay a two per cent tax on the excess, though they may have questioned the equity of a tax which side-stepped all by two per cent of the people.

Mr. Eisenstein explores the connection between ability and equality. This is embodied in the simple question as to whether twice the income should yield twice the tax or more than that. It thus involves the justification for graduated rates and the now-quaint theory that different incomes should have the same ratio after tax as before. All this emphasizes the difficulty

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of separating considerations of ability from those of equity, but to the extent that ability has been recognized in the tax law it has to the same extent abandoned equality. Perhaps this thought could be stated in another form—that the equality of such departures produces inequality of taxes. Thus the fact that "all" persons get an exemption of $X may be an equality of exemptions, but "all" persons below $X pay no tax whatever—which is certainly not tax equality.

The idea of equality, of course, can be broad or narrow. It can mean that all income should be taxed at the same rate or merely that all income of a certain kind should be taxed at the same rate. This may involve the question of ability if, for example, it is believed that the person with a given income from securities has a greater ability to pay than one with the same income from the sweat of his brow. Such a theory may be supported by the argument that the wage earner needs to save for the time when he can no longer work, while the investor has disposed of that problem—thus increasing his ability to pay. Mr. Eisenstein points out that the law has now eaten into these theories of equality through a wide variety of exemptions and special dispensations so that there can be no pretense of its survival. One example concludes with a good example of the author's style. Relief, which was originally justified because some coal lessors were built into unfortunate long-term contracts, was being given to lessors under no such disadvantage. We quote:

> Congress was unwilling to indulge in complex distinctions between one coal lessor and another. By helping all of them without discrimination, it avoided the need of writing an elaborate statute. Simplicity should not be deplored.

(Continued on next page)

REVIEWED BY

WILFRED GODFREY

treasurer, Keystone Custodian Funds, Inc., Boston, Mass., who has been a member of the CIA Federal Taxation Committee since 1947. He served as a member of the Committee's Advisory Panel for 11 years and as chairman, 1953-1954.

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SALES, SERVICE AND INSTRUCTION THROUGHOUT THE U. S. AND WORLD

Book Review *(Continued from page 555)*

When treating the corporate form as a type of special dispensation, Mr. Eisenstein admits the existence of a disincentive in the form of section 102—its new, 1954 Code number can never be remembered by those who lived in the days of Trico. He states that this penalty is "as effective as Prohibition" and that few are attentive to it. I believe his further statement that even after paying the penalty tax one might still be ahead has much more validity. There may be a good deal of avoidance by the accumulation route but I think there is a good deal of worry, often quite unjustified, on the part of the accumulators.

The author's second group, those who are concerned about the unfortunate effects of taxation on one deserving class or another, is described at considerable length. There is the brake on incentives group, those worried about the interference with savings, particularly to the extent it produces a shortage of capital, the diversion of investment into less risky ventures—and so on. The last and naturally the most exhaustively reviewed of all these groups is that which demands the right to reduce its taxable income by imaginary costs.

So much has been written and said about percentage depletion that my instinctive reaction was "No, not again." However, while the writer continues the ironic tone customarily used in discussing this matter by those not directly involved, this chapter (as I am not in the oil, sand, gravel, clam shell or oyster shell business) is the best in the book. The reason why percentage depletion, which is fancifully regarded as having been introduced to enable the poor wildcatter to drill more wells before his inevitable descent into bankruptcy, must similarly be granted to coal (of which we have an adequate supply for 2,000 years) is difficult to determine. I repeat, for those not connected with the industries in question, the chapter on "special deductions for imaginary costs" is the best in the book.

Equity, or the notion that equity has some connection with the tax law, is the subject of another chapter. The fact is emphasized that what is equitable depends on who is involved. The taxation of "higher incomes" is justifiable—provided "higher" means higher than yours. When yours becomes higher the scheme becomes palpably inequitable unless the term is redefined. Mr. Eisenstein appears to regard the income-splitting provision as a dubious and inequitable device. At times equity is a matter of degree and any arrangement may have the virtue of being closer to equity than the theory it replaced. It would seem that to treat the incomes of married people in community property states one way and those in other states in a much more expensive way needed some exploration. When it appeared that the alleged reason for the original treatment was more theoretical than real there was probably a lesser degree of inequity—between those two groups—after the change than before. The fact that the change may not have corrected the relationship between the tax on married and single persons does not invalidate it. Perhaps it aggravated that disparity by expanding it to a greater number of people. But while it was not intended to cure that ill it did provide an important and equitable adjustment as between the two married groups.

There is an old saw to the effect that one man's meat is another man's poison. That is a refrain pervading Mr. Eisenstein's discussion of loopholes. On the one hand we have Mr. Surrey to whom most deductions, credits, allowances, and differentials are schemes and devices intended to produce unwarranted benefits to one group or another. Mr. Surrey believes, doubtless correctly, that a multiplicity of such devices does not assure equity and that while Mr. A may have his little benefit and, similarly Mr. B, there is no certainty that the benefits are equal. And, even if they are, what about Mr. C? At the other end of the spectrum we have the individual or corporation with a benefit so long and firmly established that it has become a vested interest. Surrey has sound and logical arguments for the elimination of special benefits and this could broaden the base and lower the tax rate. The beneficiaries have the last-ditch, practical defense that even if what they have is unjust or inequitable or smacks of influence or special privilege, the fact is they have it and, as a matter of fact, "they" have paid for it. The villains, if any, were those who obtained the benefit in the first place and then sold its capitalized value to the present holders. It would be manifestly unfair, in these enlightened days, to visit the sins of the fathers on the children. Mr. Eisenstein enquiries: *What is a loophole?* and echo answers *What?* The last paragraph of the chapter begins with the sentence: "At this point I have completed the circle." Quite true. He is right back where he started—with the question unanswered.

One of the problems created by an unduly analytical mind is its difficulty in arriving at answers. What might have been answers get analyzed, too, and so they cease to be answers. The last chapter in our book is entitled A Restrained Con-

(Continued on page 558)

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clusion. The adjective is the most valid word. There isn't any conclusion. The tax law consists of a device on top of a scheme, an expedient defended by an argument based on nonexistent facts, a theory supported by specious platitudes which are not even believed by their authors. To approach such a document as though it were what its creators said it was is worthy of W. S. Gilbert. Macaulay would have said that every schoolboy knows that the notion is approved, the language drafted and the committee staffs are left to write up some reason as to why it might conceivably have happened. Years later if the relatively plain words of the law do not produce the answer required by the current philosophy these reasons are consulted as the oracle of "Congressional intent."

A very readable book, lively and somewhat glittering. It should be required reading for the members of the two congressional tax committees—many of whom might regard it as a very quaint book.

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Industrial Research

(Continued from page 532)

1954 to provide an allowance of a tax credit for contributions and other expenditures for basic research in science. Full tax credit for basic research expenditures by the Federal Government is tantamount to full payment for approved programs. If industrial researchers, scientists, and industrial research laboratories accept this incentive and cooperate in the planning and control of industrial research programs, the future of the nation certainly will be enhanced. It is not to be assumed that American industry has no responsibility in the spending of public funds appropriated for scientific investigations. On the contrary any lack of responsibility by a company or industry should be the subject of the most severe penalties. In the past there has been evidence that on occasions federal appropriations have produced only marginal scientific results because of a complete lack of cost consciousness and an utter disregard for what is normally considered sound, moral business practice upon the part of the contractor.

Research directors who allow the use of research funds for the purpose of permitting members of the scientific community to merely "scratch each others backs" are not only wasting private and public funds but are fostering a generation of pseudo intellectuals. By the same token, the corporate controller who attempts to regulate any R & D expenditures, regardless of the source of the capital employed, by techniques developed to control the cost of manufactured articles is equally guilty of deterring scientific advancement and destroying the economic health of industrial coporations.

American industry always has and always will make a major contribution to the scientific advancement of the nation. This it will continue to do regardless of how the reward can be measured in terms of financial, scientific or patriotic satisfaction. It behooves those responsible for the administration of federal funds for research and development, however, to assure that their efforts to protect taxpayer dollars are not in effect mechanisms whereby such dollars are not spent in the best interests of our American standard of living and national security.

If the United States is to compete scientifically with the Soviet Union and the rest of the world, and if it is to survive as a nation in the atomic age, scientific research programs must be planned intelligently and controlled to the extent that the results are used prudently. Such a course will be vitally necessary in the future to increase our national standard of living and to defend this standard of living and the lives of our citizens against any aggressor.

Regulation *(Cont. from p. 541)*

FAIR RATE OF RETURN

Now, as to a fair rate of return. I mentioned earlier that comparable earnings, cost of capital and financial safety were factors to be considered. Almost universally, the commissions have been according greatest weight and the most time and attention to cost of capital. This involves three things: the cost of debt, the cost of equity and the proportion of each. A weighted answer is unique for any company and any given time.

These items, debt cost, equity cost and capital structure, are closely related and have an effect on each other. Companies with a lower per cent of debt have lower debt and lower equity cost. The purpose of using both kinds of financing is to strike a balance between the mandatory but lower cost of bonds and the optional but higher cost of stock. There is really no way to set this ratio except by the experience of the company and other similar companies with respect to such things as the stability of the company revenue sources and acceptance of the company's offerings by people who have money to invest.

We now must decide whether to use the embedded cost of debt, or current cost of debt, or some combination of the two. We can observe the current price being paid in the market for bonds for the most recent issue of our own company and for similar companies to determine current cost. In reality, although the considerations of the investors in making their market judgments may be quite involved, it does not appear that there should be as much dispute over cost of debt in commission hearings as there has been in many instances.

COST OF CAPITAL

The cost of equity capital, or risk capital, is often the most controversial issue in a rate proceeding. This is so because it involves the greatest degree of judgment on the part of the investor who buys it and therefore on the part of the regulator who must presume to anticipate the actions and reactions of investors. Thus it represents one of the greatest areas of danger and controversy and at the same time one of the greatest areas of opportunity for the companies and commissions to contribute to economical financing and efficient operation of the public utilities.

The facts from which conclusions are drawn are earnings, dividends, market price and financing costs including underpricing. These are determined for the company in question and for comparable companies.

It is sometimes said that whatever the company or comparable companies are making at present is an appropriate test. The argument states that since investors are holding or buying stock at this level today, they will continue to do so and therefore the company will be able to raise additional capital.

As things really are, however, investors do not appear to be buying current earnings—they are buying anticipated earn-

(Continued on page 576)

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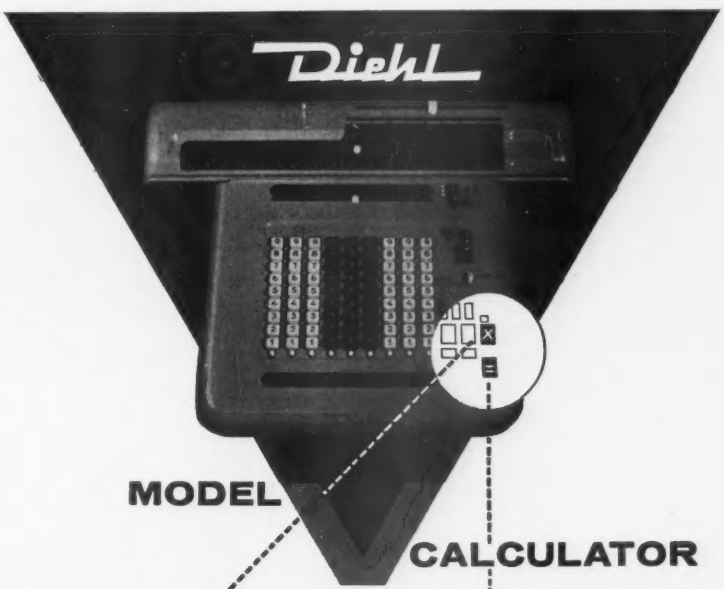

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Developing Medium- and Long-Range Forecasting

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We do two kinds of forecasting—economic or business climate forecasting (this will vary by division, and even by product somewhat) and sales volume forecasting by product lines. Let's start with the economic forecasting. In general we

1. make specific and exact use of the leading concurrent and lagging indicators. We find these are the best sources of information concerning the turning points of the general business cycle.
2. use other economic theories for the development of medium- and long-range forecasting.
3. use information we ourselves gather concerning distributors' inventories. These data we find affect the incoming orders for the next few months.
4. study the trends of business among the ultimate users of our products.
5. use trade association figures when available.
6. give careful attention to the proper "mix" of information for our own business and our own company. Incidentally, here is where forecasting becomes an art and not a science.

Now let's go into even greater detail. Let's go back to the major statistical indicators we use as recently revised by the National Bureau of Economic Research.

LEADERS

Average hours worked
Accession rate (mfg.)
Layoff rate (mfg.)
Durable goods new orders
Housing starts
Commercial and industrial building awards
Net new businesses
Failure liabilities
Corporate profits (net)
Common stock prices
GNP inventory change
Individual raw material prices

ABOUT THE AUTHOR

• RAY H. BARTLETT, *a MIT graduate, joined the Stanley Works, New Britain, Conn., in 1954 as consultant on the president's staff. In 1956, he became director of long-range planning and instituted the future planning program in this company. Previously, he was a vice president of MacDonald, Inc., Boston, Mass., where he was associated for 16 years. Mr. Bartlett, a member of the American Management Association, presented this paper before the Southern Connecticut Control of Controllers Institute of America on April 5, 1961.*

COINCIDENT

Nonagricultural employment
Unemployment rate
Industrial production
GNP (current dollars)
GNP (1954 dollars)
Bank debits outside N.Y.C.
Personal income
Retail sales
Nonfood wholesale prices

LAGGERS

Plant & equipment expenditures
Unit labor cost
Manufacturing inventories
Installment credit
Bank loans interest rate

Now let's see how these and other factors are applied to the economic forecast of the individual divisions.

*Hand Tool Division Indicators**

Housing starts
Sales inventory ratio of hardware wholesalers (National Wholesale Hardware Association)
Federal Reserve Board Index of Production
Retail Hardware Store Sales

* Indicators are in the order of their apparent significance or correlation with total industry sales. Whenever possible, indicators used are seasonally adjusted.

Power Tools—Electric and Air Tools

Federal Reserve Board Index of Production
Housing starts
Retail Hardware Store Sales

Steel Strapping

Federal Reserve Board Index of Production for such separate segments as fabricated metal products, textiles, paper, lumber, stone, clay and glass products, the industries in which we have our greatest strength.

Steel Division—(Indicators tentatively established)

Federal Reserve Board Index for total industrial production as well as Federal Reserve Board Index for fabricated metal products.
Correlated with the forecasts of our divisions that purchase steel from our Steel Division.

Hardware Division

Basic indicators include the following:
Housing starts
Contract awards for nonresidential construction
Federal Reserve Board Index of Production
Retail Hardware Store Sales
Lumber and building materials dealer sales

Note—The above indicators are correlated by product line. In other words, contract hardware will be correlated with

(Continued on page 564)

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specific portions of nonresidential construction such as construction of offices, schools and hospitals. Cabinet hardware, on the other hand, is tied in with housing starts.

Drapery Hardware Division
Housing starts

Building Specialties Division (prime aluminum windows)
Housing starts

Humason Division (stampings, springs and screw machine products)
We have investigated government figures on stampings, screw machine products and springs to establish growth trends for Stanley-Humason.

Chemical Division (industrial coatings and molded plastics)
Federal Reserve Board Index of Industrial Production

Very broad indicators such as personal income, gross national product and others have been used at one time or another in assessing the outlook for almost all divisions.

In many instances we have to get "behind the indicators" to forecast the indicators themselves. For example, we examine population figures and household formation rates to enable us to forecast housing starts.

We forecast the immediate (12 months) climate which is adjusted quarterly and in addition we will issue reports on economic climate factors even more frequently if we feel there are significant trend changes. Each year in preparing the long-range plans, our Market Research Department will forecast the potential total market by years for five years and, in most cases, by major product lines. Throughout the year they will also provide at irregular periods special reports such as "The Outlook for Residential Housing."

Sales forecasting at the Stanley Works is done by our divisional marketing groups in coordination and with the advice and counsel of the divisional sales groups. The procedure is basically a part of long-range planning and you will see this close connection in the steps in our method of forecasting sales volumes:

1. Determine objectives
   a. Volume
   b. Profit
   c. Share of market
   d. Diversification
   e. Use of present facilities
2. Determine strengths and weaknesses
   a. Product lines (including obsolescence rates)
   b. Organization
   c. Manufacturing facilities
   d. Reputation or brand acceptance
3. Choose areas in present line for concentration
4. Make recommendations for eliminating unprofitable and obsolescent products
5. Compute, in general terms, the need for additional *lines* of product
   a. To make
   b. To buy
6. Collect all new product ideas presently available
   a. Engineering Dept.
   b. Salesmen
   c. Marketing and sales staffs
   d. Customers
7. Evaluate new product and new product line ideas
   a. Market and product research (if necessary)
   b. Marketing staff evaluation
   c. General and sales management approval
8. Recommend new product specifications
9. Outline a long-range product plan by years (five years)
   a. Seasonal promotions

(Continued on page 566)

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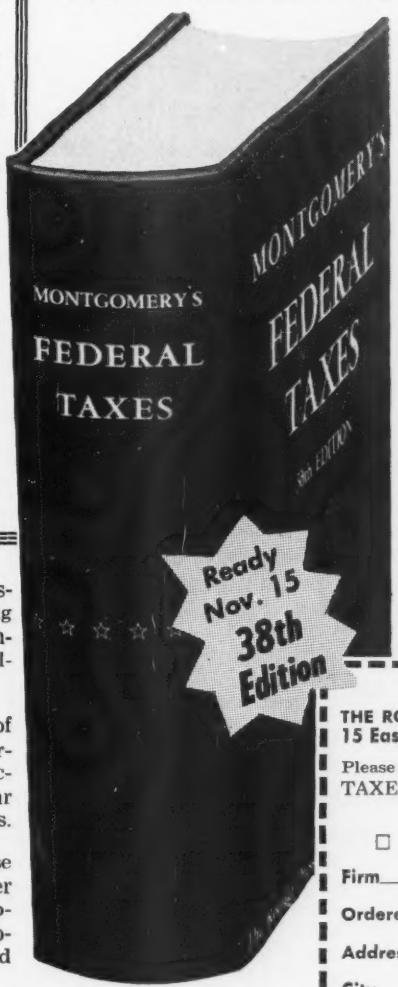

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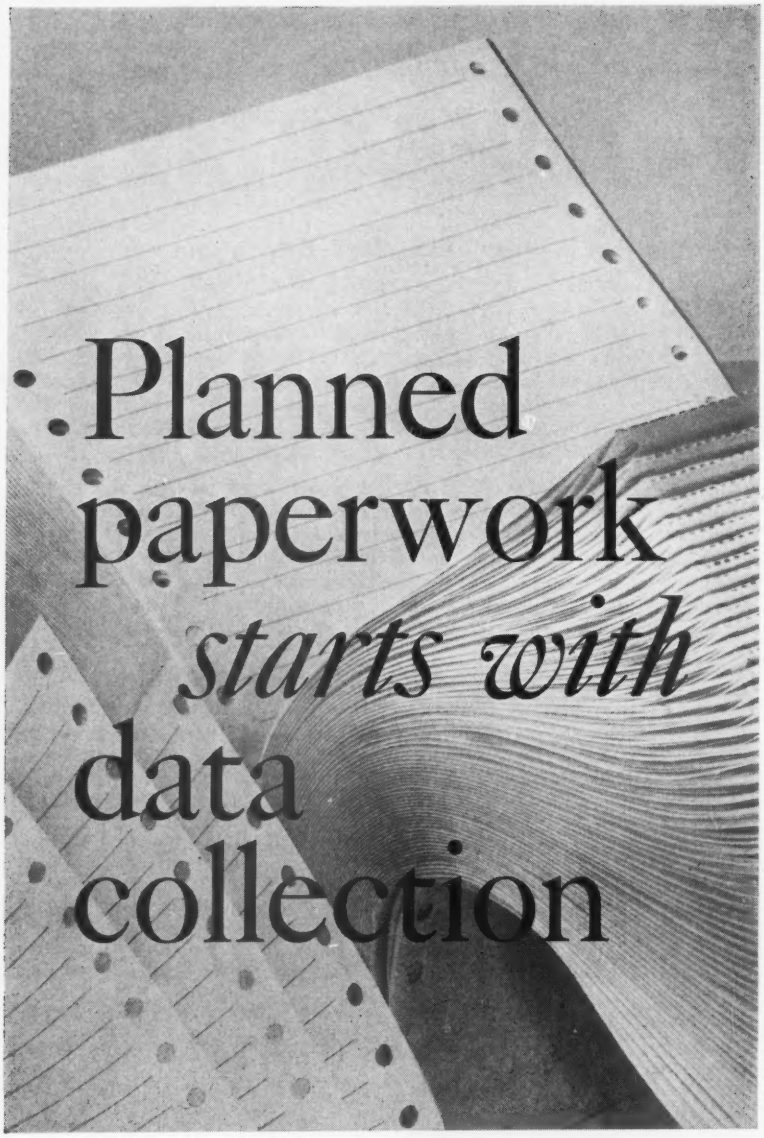

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Business Forms and Forms Handling Equipment for Paperwork Simplification

Forecasting *(Continued from page 564)*

b. New product introductions

10. Compute long-range forecast
    a. Present lines considering following factors:
        (1) Past sales experience
        (2) Obsolescence rate
        (3) Strength of competition
        (4) Economic forecast
    b. New product lines considering following factors:
        (1) Strength of competition
        (2) Distinctiveness of product
        (3) Completeness of promotion
        (4) Market potential as determined by commercial research or division marketing dept.
        (5) Pricing
        (6) Actual sales of a related product if there is a relationship

Each product and/or product group would then be forecast in units and extended in dollars for five years.

11. Schedule on annual promotion plan
    a. Seasonal promotion
    b. New products
12. Detailing the annual forecast includes the following:
    a. Revaluation of long-range program
    b. Seasonal factors are applied to get quarterly unit quantity
    c. Lines affected by our new products are reduced accordingly
    d. Lines affected by competitive products are reduced accordingly
    e. Special promotions and their effect on forecast are applied in the annual forecast
13. Draw up in detail a marketing plan for each new product and/or new product lines (one year)
    a. Description of products
    b. Competitive study
    c. Pricing
    d. Profit study
    e. Packaging
    f. Literature required
    g. Features
    h. Announcement dates
    i. Display
    j. National advertising
    k. Forecast

But this isn't all, we then—

Review long-range marketing plan annually and make revisions

Review long-range product plan monthly or quarterly and make revisions

Review sales forecast monthly or quarterly and make revisions.

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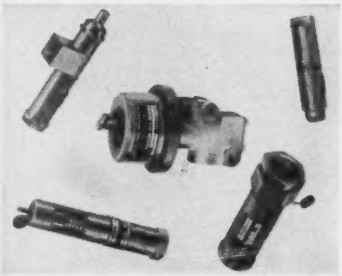

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"Figures show that our NCR Accounting System saves us $8,500 a year, paying for itself every 10 months. But we can't measure in dollars and cents many intangible returns, such as neatness, less employee tension, etc., that are automatic by-products of the System. We are tremendously pleased with our NCR System."

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Controller
Vinson Manufacturing Co., Inc.

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Community Relations in a Host Country

The emergence of American-owned global companies, maintaining corporate citizenship in many countries, presents problems in international community relations. Problems of language, different cultures, varying levels of literacy and psychological reactions to circumstances are among the many complex factors which distinguish the international audience.

Any company contemplating a substantial foreign investment should incorporate in its over-all planning for each country measures to insure foreign approval, says the National Foreign Trade Council.

Specific objectives of such plans would seek to earn the understanding and acceptance of the host community; to promote wider understanding of the ways in which the company serves the community interests; and to identify the company as a responsible citizen of the host community, worthy of the community's respect and confidence.

NFTC cites various techniques that may be employed in dealing with community opinions. These include:

1. The personal activities of the senior officer present and his key executives;
2. Opinion polls, press releases, institutional advertising;
3. Internal and external house organs, bulletin boards, booklets;
4. Speakers bureaus, films, exhibits, and company support of civic and cultural organizations, meetings with and mailings to community thought leaders;
5. Scholarship and apprentice training programs, loan of company facilities, equipment and professional skills to schools and civic groups; and
6. Charitable contributions.

In its communications a company should show how its activities benefit the host community and nation and contribute directly to the local economy. These might include facts about the number of jobs created, the size of the payroll, taxes paid locally, services purchased locally and their relation to profits. A leading cause of friction in host countries is a misconception about the nature of profits, based on the misunderstanding of the fact that a company's first obligation to its employes, stockholders, suppliers and customers is to operate profitably in order to exist. A well-informed community opinion is the best defense against hostility; the withholding of information leaves a vacuum which invites distortion of the truth.

A key point, the NFTC believes, upon which many foreign enterprises win or lose public acceptance is the development of local nationals. No program to win public acceptance in a foreign country can be complete or effective over a long period unless it provides for the development and advancement of local nationals, including advancement to management levels.

Controllership in Action

Collegiate teachers of business in New York and neighboring states have been invited to attend an all-day seminar on "Controllership in Action" jointly sponsored by the New York City Control of Controllers Institute of America and the Graduate School of Business Administration of New York University. The meeting will be held on November 8 from 9:30 a.m. to 4:30 p.m. at New York University.

The objective of the seminar, to be held exclusively for business faculties of universities and colleges, is to illustrate the organization and operation of the controllership function in a large, diversified, and decentralized industrial corporation, thus demonstrating in a very practical way the positive contribution of accounting to management. The president, vice president, controller and other key financial executives of the American Machine and Foundry Company will participate in presentations and discussions.

We are seeking a controller between the ages of thirty-five and forty-five, with a top academic background and considerable experience in manufacturing cost determination and control. Experience in steel products manufacturing of such products as welded tubing and stampings would be most helpful. Location, small industrial city in Northeastern Ohio. Salary, fifteen to twenty thousand dollars a year, dependent upon experience. Good future for the right man. Box No. D 2529.

The Controller

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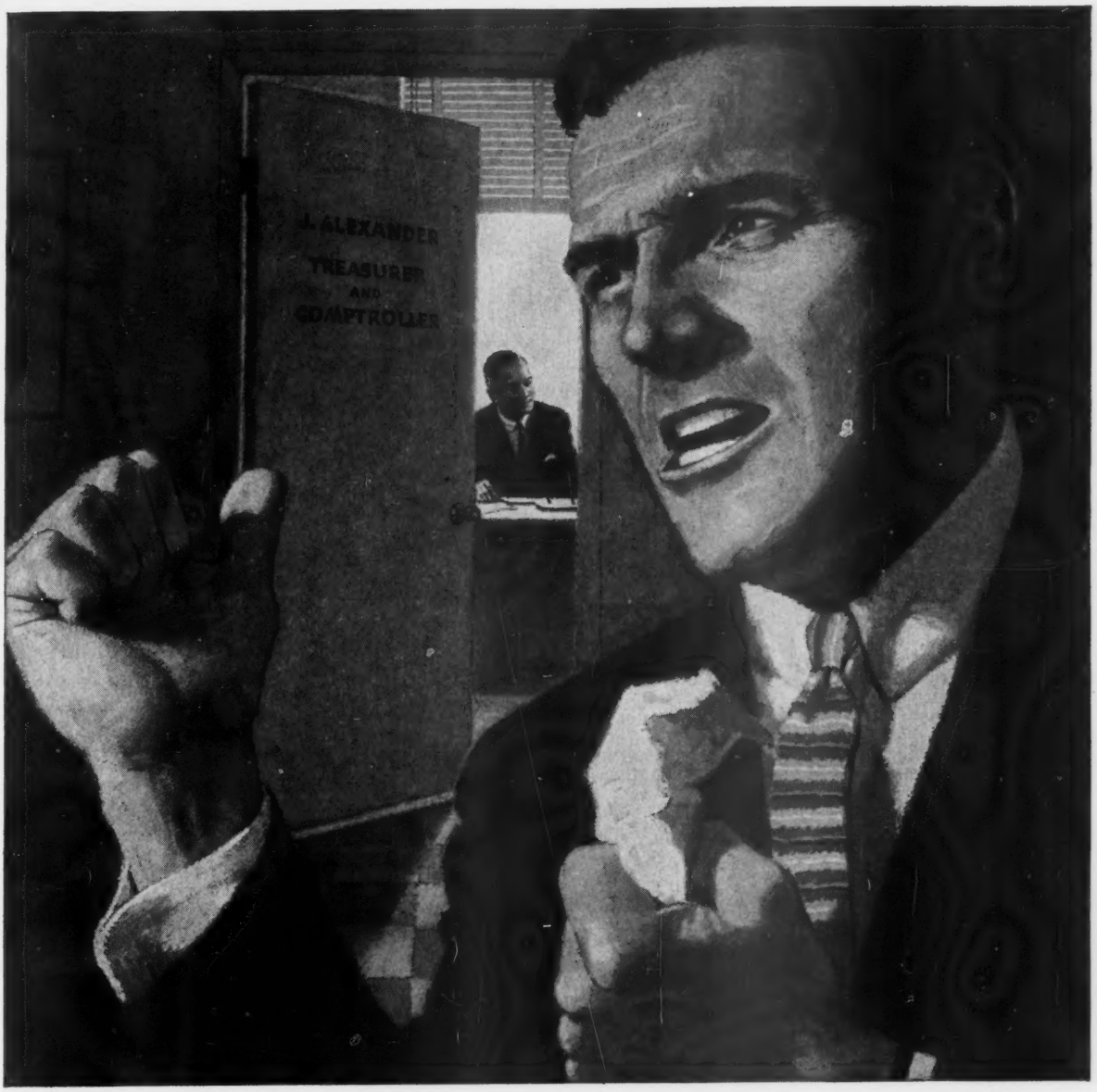

Now he's killed the sales meeting in Nassau!

Joe Alexander really doesn't enjoy saying "no." But somebody has to do it now and then. In fact, Joe's job as treasurer and comptroller calls for hard decisions almost every day. Decisions that sometimes are downright unpopular.

He knows the importance of *sales*—and what it costs to get them. He's not dead-set against any and all spending. But nobody knows better than a corporation financial officer that pennies wisely pinched often add up to new plants, new markets, new opportunities for profit.

Here at C&S in Georgia we know from experience that today's financial officers frequently require a lot of selling. But they do respond to business-building ideas that make long-range sense for their companies.

C&S today is helping many companies like yours cut costs, and finance sales in the Southeast. Perhaps you'd like to know how they make deposit-dollars work overtime.

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Rewarding Employes' Inventiveness

All employes of Martin Company, Baltimore, Md., assign their inventions to the company and share in the benefits of the programs which have been established to stimulate creativity and reward inventors.

Among these programs is one which provides cash awards for meritorious disclosures, whether patentable or not, soon after the employe has disclosed his invention to the company. Under this system, an employe's invention is reviewed by a high-level committee very shortly after it is disclosed to the company, usually within a month.

At this time, if in the opinion of the committee, the disclosure of invention exhibits sufficient ingenuity or has sufficient value to the company, a cash reward of $25.00 to $1000.00 is granted. This amount is subject to increase in exceptional circumstances.

By providing an award at this early date, the Martin Company brings an immediate benefit to the employe and this, they believe, encourages prompt disclosure of inventions.

During the first six months of this year a total of 158 disclosures was evaluated. Of these 37 were determined to merit an invention award and the awards granted exceeded $7,300.00. The average award granted was therefore about $200.00.

In addition to the invention award system and in addition to a token award of $50.00 which is given to each employe at the time a patent application is filed in his name, the employe is entitled to share in any profits realized from the license or sale of the patent in his name. The extent of his share is 20 per cent of the first $100,000 received by the company, 10 per cent of the next $400,000, and five per cent of any amounts in excess of that figure.

The Martin Company currently has under study and expects to put into effect in the near future an extension of this royalty-sharing program. Under the proposed extension of the program, an employe would be permitted to share in profits attributable to the use of his patented invention, even if the patent were not licensed.

Finally, since the Martin Company does not wish to suppress the use of any invention, great liberality has been exercised in granting releases which assign back to the inventors those inventions in which the company has no substantial interest.

FILES CROWDING YOU OUT?

Business papers are filed to be retrieved quickly when needed. Why clutter expensive filing cabinets and needed office space with obsolete records, making needed records difficult to file and find? Over 300 client companies have safely destroyed 30 to 50% of their records reducing unnecessary overhead costs for space, equipment, time and personnel.*

Naremco (National Records Management Council) has pioneered in creating and installing effective management controls for:

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- **Uniform file classification systems for pinpoint location.**
- **Vital records protection.**

* Case histories describing new techniques and cost reduction opportunities are available on request.

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"That he who runs may read"

The financial division may be expert in coordinating financial resources, production capacity and market potential but how about its artistic capacity? A new manual entitled "Comprehension of Graphs" (issued by the Department of Agricultural Journalism, College of Agriculture, University of Wisconsin, in cooperation with the United States Department of Agriculture Office of Information) is a compilation of a study prepared as theses by two graduate students.

Chapter III, for example, differentiates between the designs possible to use to tell a visual story in reports or annual reports and graphically illustrates such pointers as:

Bars are easier to understand than lines; grouped format generally is better than segmented; figures-on-elements are easier to understand than grids; labels are generally easier to understand than keys; word labels or pictorial symbols are equally good; pictorial symbols are better than keys and horizontal or vertical bars; take your pick!

Chapter V covers the relation of reader characteristics to graph comprehension from the three lowest deciles of IQ scores to college-graduate executives. The authors imply that if people who prepare graphs are in the high IQ level, their own ability to interpret a graph is not a safe basis for assuming that people generally (such as stockholders) will be able to interpret it.

They also state that much graph research still is needed to provide a better basis for using graphs to communicate with the American public and train it in numerical, verbal and abstract reasoning which is significantly related to graph comprehension.

There is a 29-item bibliography to further shed light on graph designing and pictorial illustration in presenting company information.

Nonresident Investment Fostered

To encourage foreign investment in its securities, the Japanese Government has lifted the restrictions on purchases of bonds by nonresident foreigners. Hereafter, Japan will automatically approve the purchase, from foreign currency holdings or nonresident deposit accounts, of long-term corporate, government, municipal and other bonds, which will expire more than two years after date of purchase. Interest is convertible into foreign currency for immediate transfer out of the country. Upon maturity, the redemption value will also be automatically approved for remittance in foreign currency.

Purchase of government short-term bonds from foreign currency holdings on nonresident accounts will be automatically approved but remittance of principal abroad must await the bonds' maturity. However, remittance will be limited to bonds purchased from foreign currency holdings and will not be permitted for bonds purchased from nonresident accounts.

Dividends from monetary trusts may be transferred abroad but the principal may be remitted in foreign currency only (1) if invested under the terms of the foreign currency trust agreement and (2) redeemed upon maturity or cancellation after a two-year period.

Interest on balances in nonresident deposit accounts will hereafter also be remitted automatically in foreign currency.

New Research Projects

The American Institute of Certified Public Accountants has recently added three new projects to the agenda of its Accounting Research Division. They are *Accounting for Foreign Operations; Intercorporate Investments;* and *Price-Level Changes.*

Any individual, group, or association interested in submitting comments, suggestions, or other materials for the use of the research staff on any of these projects is invited and urged to do so. All correspondence should be addressed to Maurice Moonitz, director of Accounting Research, AICPA, 270 Madison Avenue, New York 16, N. Y.

For Statistics Fans

Assets of the General Electric pension trust have passed the $1 billion mark; a total of 226,270 employes are participants as of July 1961 reports.

*

The daily volume of shares traded on the New York Stock Exchange has increased from 750,000 in 1940 to 3,342,000 in 1959 and should reach 5,500,000 by 1970. In banking the number of checks cleared has increased from 8 billion in 1952 to 13 billion in 1959 and may reach 22 billion in 1970.

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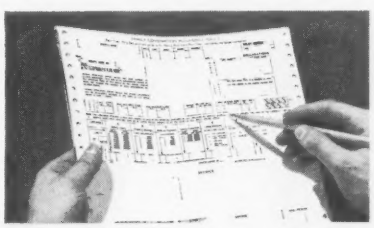

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Personal Notes

TOP MEN . . .

Leonard F. Beckers is now president of the California Economics Research Corporation, Palo Alto, Calif. . . . **Dante C. Fabiani** was recently elected to the presidency of Crane Co., New York.

COMPANY CHANGES . . .

Edmund Leone is vice president-administration and **Colin MacLennan** is controller of the Manufacturers Hanover Trust Company, New York, following the merger of Manufacturers Trust and the Hanover Bank. . . . **Ernest C. Brelsford** was named vice president-finance of Thompson Ramo Wooldridge, Inc., Cleveland. He is succeeded by **Elmer E. Stuart** as treasurer. . . . Seaboard Finance Co., Los Angeles, Calif., recently announced that **H. Wallace Merryman** is now treasurer and **Owen Metzler** is comptroller of the company. . . . **Leon H. Neiman** was elected vice president and treasurer of the Camden Trust Company, Camden, N. J. **Howard C. Mayhew, Jr.** succeeds him as comptroller. . . . **Albert J. Buckenmyer** was elected treasurer of Midland-Ross Corporation, Cleveland, Ohio; **Donald M. Smith** is now controller. . . . **John W. Hartley** was named treasurer and secretary of Gladding, McBean & Co., Glendale, Calif., succeeding **Robert A. Eccles** who retired.

NEW CONNECTIONS . . .

Donald F. Burns recently became assistant comptroller of American Cable & Radio Corporation, New York. . . . **John W. Clarke** has assumed the responsibilities of vice president at Richardson Corporation of Greensboro, N. C. . . . **Aubrey C. Dickson** is now assistant to the chairman of the board of Wallace Hy-Cross Hatcheries, Inc., Doylestown, Pa. . . . **James J. Doyle** has been named vice president-finance of Curtiss-Wright Corp., Wood-Ridge, N. J. Mr. Doyle is currently serving as a director (Region III) of Controllers Institute.

National Manufacture and Stores Corporation, Atlanta, Ga., recently named **Paul D. Hausenbauer** its controller. . . . **H. P. Huebner's** new responsibilities are those of director of purchasing of Nalley's Inc., Tacoma, Wash. . . . **Daniel P. Knowland, Jr.** is now director of finance of Shulton Inc., Clifton, N. J. . . . **John N. Latter** recently became controller of Ampex Corporation, Redwood City, Calif. . . . The election of **Walter E. Lucie** as treasurer and controller of Soundscriber Corp., North Haven, Conn., has been announced.

Jay R. Meyering is controller of Indianapolis Drop Forging Company, Inc., Indianapolis, Ind. . . . **Stuart B. Miller** is vice president and director of finance of Chicago Rawhide Manufacturing Company, Chicago, Ill. . . . The new treasurer of Textile Machine Works is **William P. Porch,** Reading, Pa.

Donald J. Schreiber was elected vice president-finance of Guerdon Industries, Inc., Detroit, Mich. . . . **Sheldon L. Spelman** has assumed the responsibilities of vice president and comptroller of the First Western Bank and Trust Company, Los Angeles, Calif. . . . **L. E. Wiles** recently joined the financial staff of the Motorola Company, Chicago, Ill. . . . **Albert R. Carpenter** is now controller of Mack Trucks, Inc., Plainfield, N. J.

ADDED RESPONSIBILITIES . . .

Samuel T. Gustina has been elected vice president and controller of Aluminum Company of America, Pittsburgh, Pa. . . . The election of **Jay E. Hummer** as assistant treasurer, comptroller and a director of the General Crushed Stone Company, Easton, Pa., was announced recently. . . . **J. Robley Janssen** recently became vice president and controller of Lockheed Aircraft Corporation, Burbank, Calif. Mr. Janssen is currently serving as president of the Los Angeles Control of Controllers Institute.

Frank B. Powell is senior vice president and controller of Security National Bank of Long Island, Huntington, N. Y. . . . Kennecott Copper Corporation, New York, has assigned the duties of treasurer and comptroller to **Gordon B. Russell.** . . . **Russell Wetmore** is vice president and controller of Mutual of New York, N. Y. . . . **Frank Frain** recently became vice president and treasurer of Lockheed Aircraft Corp., Burbank, Calif. . . . **Edward F. Dolansky** has been appointed vice president-finance and treasurer of Frontier Airlines, Inc., Denver, Colorado.

NEW APPOINTMENTS . . .

Charles J. Hickey is comptroller of West Virginia Pulp and Paper Company, New York. . . . **Arthur Snyder, Jr.** has been named controller of the Behr-Manning Co. Division of Norton Company, Troy, N. Y. . . . **Chester F. Perkins** was named vice president and treasurer of Laconia Savings Bank, Laconia, N. H.

MR. BECKERS

MR. FABIANI

MR. DOYLE

MR. LUCIE

MR. JANSSEN

MR. DOLANSKY

MR. C. H. BURNS

MR. BEVARD

MR. CHAMBERS

MR. ZWISLER

MR. FREEMAN

. . . **Carl H. Randall, Jr.** is controller and auditor of the Binghamton Savings Bank, Binghamton, N. Y. . . . **William T. Rapp** recently became vice president and comptroller of ITT Federal Laboratories of International Telephone & Telegraph Corp., Nutley, N. J. . . . **Timothy H. O'Leary** has been appointed controller of National Beryllia Corporation, Haskell, N. J. . . . Gregory Industries, Inc., Lorain, Ohio, has appointed **Frank H. Kettle** as controller. . . . **William J. McCormick** has been named controller by Alloys Unlimited, Inc., Long Island City, N. Y.

NEW DIRECTORS . . .

Dean James W. Culliton of the College of Commerce, University of Notre Dame, Notre Dame, Ind., to the board of the Chicago, South Shore and South Bend Railroad Co., Michigan City, Ind. . . . **Thomas H. Carroll,** president of George Washington University, Washington, D. C., to the board of Peoples Drug Stores, Inc., same city. . . . **Lester T. Moate,** vice president and treasurer, American Steel Foundries, Chicago, Ill., to his company's board.

HONORS TO . . .

The newly elected president of the Atlanta Control of Controllers Institute, **Charles H. Burns,** vice president-finance and treasurer, Fulton Industries, Inc., Atlanta, Ga.; and **Dale E. Bevard,** treasurer, Nelly Don, Inc. who was elected president of the Kansas City Control.

PROMOTIONS . . .

Paul A. Altpeter was appointed controller for Allerton Chemical Company, Inc., and Brooks Research Inc., Rochester, N. Y. . . . The election of **Robert A. Briggs** as treasurer of the Gillette Company, Boston, Mass., was announced recently. . . . **Thomas Chambers** is now treasurer-comptroller and manager of the financial division of British Columbia Electric Company, Ltd., Vancouver, British Columbia, Canada. . . . Purex Corporation Ltd., Lakewood, Calif., has named **George A. Evans** its vice president-finance.

The appointment of **Edward G. Kontos** as treasurer of P. Lorillard Company was announced recently. . . . **Edward C. Hastings** was elected assistant treasurer of Hercules Powder Company, Wilmington, Del. . . . **Robert A. Lineberger** has been appointed controller of Beckman Instruments, Inc., Fullerton, Calif. . . . **Malcolm C. Stewart** is now vice president-administration and finance, the Gillette Company, Boston, Mass.

James Lee Wadsworth was named comptroller of the American National Bank, Gadsden, Ala. . . . **H. F. Worthen** recently became vice president and treasurer of First Federal & Loan Association, Phoenix, Ariz. . . . **Joseph E. Zwisler** has been named assistant treasurer of the Falk Corporation, Milwaukee, Wis. . . . **J. C. Freeman** has been named administrative vice president of J. I. Case Company, Racine, Wis. . . . **Virgil A. Burks** was recently elected treasurer of Shwayder Brothers, Inc., Denver, Colorado.

SPEAKERS . . .

Participants in the American Management Association's Seminar on Finance at the Hotel Roosevelt, New York, October 30-November 1, were: **Charles V. Boulton,** treasurer, International Business Machines Corp., New York; **Robert J. Johnston,** comptroller, Foote Mineral Co., Philadelphia, Pa.; **Ernest A. Carlson,** controller, Johnson & Johnson, New Brunswick, N. J.; **David W. Chappuis,** controller, Celanese Corporation of America, New York; **L. C. Guest, Jr.,** vice president and controller, General Telephone and Electronics Corp., New York; and **James J. Doyle,** vice president-finance, Curtiss-Wright Corp., Wood-Ridge, N. J.

EXTRACURRICULAR ACTIVITIES . . .

L. E. Felton, president, Green Giant Company, LeSueur, Minn., has been named to the governor's tax advisory committee, State of Minnesota. . . . **Charles V. Boulton,** treasurer, International Business Machines Corp., New York, was re-elected as vice president in charge of the Insurance Division of American Management Association.

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Business and Industry Prepare for a KO

WHILE THE WORLD is weighing the possibility of a cold war turning into a hot one, business and industry are slowly but surely beginning to weigh the ounce of prevention necessary for survival in the wake of a sudden nuclear attack on this country. It is not a new attitude, merely a revival of the precautionary measures started back in the early 50's that have since become relaxed. Impetus for revival has come in many cases from the concerted efforts of associations acting as a focus for member units in preparing a forward-looking plan for safety of personnel, records, utilities, transportation, and not the least important, the succession of executive control in case of loss of key men.

Government bureaus are cooperating with over-all countrywide advice and help in the various phases of national defense that tie in definitely with the continuing operation of our economy under and after attack. The range begins with the family shelter and leads up to a network of safety centers for multiplant organizations.

Surveys made by the Federal Reserve Board, the *New York Times* and other groups show generally an up-to-now indolent and indifferent attitude on the part of many companies to the possible danger to survival. One could be alarmed at the figures reported in surveyed areas such as banking—the life line of business transactions—which show that of 13,364 banks who replied last June to the FRB questionnaire, only 916 said they had even a minimal preparedness program; retail and supermarket stores have done little; it is reported that only 20 per cent of the key factories in Southern California have extensive protective measures.

Foresight and preparedness, however, reach a higher pitch with the electric utilities companies, insurance companies, telephone companies and stock exchanges and their members. In many cases, providing for the storage of important corporate documents, microfilmed or duplicated, and equipment replacements necessary to "keep going" has been a continuing concern of the larger corporations in this country since the first atomic bomb was dropped. Records depositaries have been established at various locations—mainly rural —within accessible distances from the larger cities or supposedly critical manufacturing or defense points that might be attacked. Many companies have underground or aboveground alternate headquarters that could insure "business as usual" to a practicable degree.

Utilities and transportation have their own limitations to cope with aboveground and the precautionary measures in their fields consist of thoughtful and thorough planning for pooled electric power and alternate switching centers removed from what might be the directly affected areas. Railroads have for several years had a disaster plan prepared by the Association of American Railroads and the American Short Line Railroad Association with the approval of the Interstate Commerce Commission. In July 1961 the American Trucking Association distributed to its member trucking companies transport mobilization orders prepared by the Interstate Commerce Commission. Plans are getting under way for emergency survival programs applicable to ports and maritime shipping as well as to airlines.

In the regional* survey made and reported on by the *New York Times* in its October 1, 1961 edition, plans of many of the country's largest organizations are briefly cited but give a comprehensive listing of measures being taken in the event of disaster great enough to cripple the effective operation of business and industry.

Activities include microfilming and off-premises storing of records; designation of alternate operating offices; providing for the evacuation of employes or protection in on-premises shelters; and first aid training of employes. Some plants, with employes in the thousands, maintain a 100-cot hospital and operating room; a stockpile of medical supplies and food rations; even water wells, independent communications systems and emergency generators are included in their plans. There are hookups with the Conelrad warning system; management in depth charts; and fully detailed mobilization schedules for personnel in force—if and when. One com-

* Atlanta, Boston, Chicago, Dallas, Detroit, Los Angeles, New York, Omaha, Pittsburgh, Philadelphia, and Seattle.

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Illustration courtesy National Association of Manufacturers from a booklet entitled "Beyond the Horizon" *published 1949 (now out of print).*

COMMITTEE ON CORPORATE DISASTER POLICIES BEING FORMED BY CONTROLLERS INSTITUTE

A study of corporate disaster policies is being made by a newly formed committee of Controllers Institute, according to that organization's president, Arthur L. Boschen, vice president-finance, Richardson-Merrell Inc., New York.

Serving as chairman of the committee is Max S. Simpson, controller, Socony Mobil Oil Company, New York, while the vice chairman is Steve H. Bomar, senior vice president and secretary-treasurer, Trust Company of Georgia, Atlanta. Other members will be announced at a later date.

The committee will consider corporate policies in the event of enemy attacks as well as in times of natural disasters.

pany is purchasing bulk qualities of building materials for family shelters and allowing employes to buy the materials at cost, paying for it through payroll deductions over an extended period.

Along the lines of civil defense, the *Times* reports that Western Electric Company, with 4,000 employes, has done the most preparation. There is a shelter for all employes, emergency water and food supplies, medical supplies, trained rescue squads and fall-out measurement groups. The company has its own warning system and emergency communications and is in the process of microfilming records and setting up a line of executive succession. These measures are perhaps heightened by the fact that this Omaha company is located practically on the doorstep of the headquarters of the Strategic Air Command.

Throughout the country "thinking about it" and preparing are spotty but there has been a marked speeding up of preparations as the international situation worsens. Virgil Couch, industrial director of the Office of Civil and Defense Mobilization in Battle Creek, Michigan, states that mail recently has been piling up in that office at the rate of 6,500 letters a day, 15 times normal, mainly asking questions about industrial defense.

There are a few off-beat sides to the general procedures. For instance, one dairy company plans to shelter 200 head of dairy cattle—a 20th century Noah's Ark angle; Firestone's cavernous underground vaults, used to store new rubber, can provide shelter for all employes of one shift; records are stored in former mushroom-growing caves; converted salt and limestone mines; and even in a former ammunition dump.

The complaint across the nation, says the *Times,* is that no *master plan* for the entire continent has as yet evolved from the many smaller precautionary preparations that have long been in effect and are due to be intensified in the next few months. True, some interdependent defense industries have made mutual arrangements to operate by taking over personnel, to use one another's facilities, and to fight fire together if catastrophic effects of nuclear warfare bring about emergencies that need everyone's all-out cooperation to survive, but many believe that the Federal Government falls short on any unified plan for assisting industry to prepare for nuclear attack.

RELATED READING from THE CONTROLLER

TACKLING THE PROBLEM OF RECORDS RETENTION, Paul Haase, March 1950.

BOMBS DO NOT RESPECT VITAL BUSINESS RECORDS! Emmett J. Leahy and Robert A. Schiff, March 1951.

RECORDS PROTECTION: What Is Being Done, by Whom, and How, September 1951.

HOW KANSAS CITY FIRMS' RECORDS ESCAPED DAMAGE BY FLOOD—NEW YORK AREA PLANNING PROTECTION—HOW MONSANTO RECOVERED ITS TEXAS CITY RECORDS, September 1951.

HOW GILLETTE PROTECTS ITS RECORDS, Richard N. Rigby, October 1953.

THE CONTROLLER'S ROLE WHEN DISASTER STRIKES, Edwin E. McConnell and William H. Perks, January 1955. (Reprint available—40 cents.)

FLOOD COSTS AND GOVERNMENT CONTRACTS, Paul M. Trueger, December 1955.

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Nation's Business is offering reprints of an article published in its September 1961 issue entitled "What To Do in Case of War"—address the magazine at 1615 H Street, N.W., Washington 6, D. C. Ten cents a copy or $7.00 per 100 postpaid. Please enclose remittance.

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Regulation *(Cont. from p. 561)*

ings and/or price appreciation. This point could hardly be driven home any more emphatically than it has by recent trends in the markets, for the dividend price ratio has dropped below bond yields. Obviously, investors would buy bonds in preference to stock if they were interested solely in current receipts.

Better ways are open to us.

One is to examine the *trend* of earnings with relationship to market price. The other is to compare utility earnings with the earnings rates of nonregulated companies. These are realistic in that they are what an investor does before investing and they are legal in that comparability of earnings is specifically called for in such famous cases as Southwestern Bell and Hope Natural Gas. Both approaches should be used, and the results of each can be normally expected to be within a reasonable range of each other.

Now we have finally developed what we may call the cost of capital. The approach we have used, however, has led us to the minimum cost of capital in order to compete with other companies for investor dollars. Thus we have a minimum rate of return—and to stick with the minimum is to flirt with going under the minimum—sort of like trusting to a minimum doctor—or letting yourself be kept afloat by a minimum swimmer.

Justice Brandeis, in discussing capital charges, says that, "The reasonable rate to be prescribed by a commission may allow an efficiently managed utility much more." Consequently, we must examine our earnings figure still further to be certain we have given adequate attention to our financial safety and to the comparison of our earnings with other companies.

Having now obtained a fair rate of return we can multiply it and the rate base obtained earlier and derive our authorized net earnings.

From this is to be subtracted present net earnings, i.e., for the test period, to determine a net increase. Here again, we must stop for adjustments since many commissions have disallowed certain expenses and some companies have claimed upward adjustments. Most of them have been based on assumptions that companies could have operated differently than they did. They have included advertising, pension costs, depreciation, intracorporate expense transfers, contributions, organization dues, income taxes and other items, such as nonrecurring expenses.

So now we have determined the net increase in earnings which is to be allowed. To this must be added the effect of corporate taxes to determine the gross increase. This doubles and a little bit more the cost to the consumer.

REGULATORY LAG

One other aspect of regulation merits mention and that is regulatory lag. Rates should be determined for the future by the procedure outlined, which is based upon the past, so that even if the commissions act almost instantaneously there would be some lag. However, deliberations and findings take time. The average interval between the filing of a rate case and the institution of new rates is about eight or nine months, or much more in some cases, so that by the time these rates go into effect the utility has been operating with a revenue deficiency for some time.

PUBLIC PRESSURE

I have purposely ignored up to now a factor which sometimes seems to override all others in its impact on this whole process. To have been complete I should have mentioned it in connection with each argument that we have discussed because it has loomed in the background each time. What I am talking about is public pressure. I shall call this short-term public pressure. No one wants to pay more for anything and thus this pressure is perfectly natural and to be expected. Counter-balancing this, to a greater or lesser degree, is long-term public need for good utility service.

I might point out that regulation cannot guarantee utilities against losses. It may put a ceiling on profits but it is unable to put a floor under them. Should this be doubted—ask the owners of many railroads when they last saw a dividend check.

LONG-RANGE PLANNING

It would not be proper to conclude without some reference to the position of utility management with respect to earnings. I think it can be stated very simply. Since the tendency of regulation is to work on a cost-plus minimum earnings basis, this inhibits the normally strong competitive urge to be more efficient and sell more of your product and make more money. *Why bother if the known result of an increase in profits would be an order to reduce the profit to its previous level?* Regulation must develop techniques for stimulating management efficiency by allowing them some of the fruits of their efforts in the form of higher earnings. The attempts to date to disallow certain expenses and to tie earnings to a bare cost of capital have not been in this direction. More enlightened regulatory action in this regard would encourage long-range planning which might lower earnings temporarily but would pay off handsomely to both consumers and investors in the long pull.

To bear this out are numerous studies indicating that businesses with higher profits generally provide better service or products at lower prices than do businesses with low profits. This is true of both regulated and nonregulated businesses. And I guess we should not be surprised—it is really difficult to imagine a business that can be half-way successful for any period of time.

It can be shown that the customers of the 25 electric power companies with the highest rates of return pay less for their electricity than customers of the 25 companies with the lowest rates of return. Incidentally, 20 of the top 25 are in "fair value" jurisdictions and only two of the bottom 25 are in the "fair value" jurisdictions.

In summary, it would appear that the greatest benefit to all occurs when the regulatory authorities are best able to function as a substitute for competition.

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